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HEARING ON  
CHINA AND THE CAPITAL MARKETS

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P R O C E E D I N G S

CHAIRMAN D'AMATO: The hearing will come to order. Today, the U.S.-China Economic and Security Review Commission will have a hearing on China's Strategy and Objectives in the Global Capital Markets. I'd like to thank Commissioner Mike Wessel to my right and Vice Chairman Roger Robinson for chairing this hearing and for continuing to focus the Commission's attention on the important topic before us, and today's panelists, thank them in advance for offering their informed perspectives on the issues.

The economic and security challenges for the United States, and particularly from our point of view American investors and holders of mutual funds on China stocks and bonds--firefighters, policemen, teachers, workers--the challenges for the United States and our constituents stemming from the increased incursion of Chinese firms to the global capital market is certainly one of the most unique issues of our mandate from the Congress, and this--to repeat our mandate, Part D of the congressional

mandate for this Commission--is that we shall evaluate the extent of Chinese access to and use of United States capital markets, whether the existing disclosure and transparency rules are adequate to identify Chinese companies which are active in United States markets.

These issues have significant implications for U.S. institutional and portfolio investors looking to purchase stock in Chinese firms, as well as financial analysts tasked with unraveling Chinese companies' complex web of relationships and finances.

As Chinese financial institutions prepare today, we understand, for an estimated combined \$15 billion in listings, questions need to be raised regarding the loan portfolios of these institutions. I am concerned that U.S. investors may not have sufficient information to make informed decisions about the risk of these investments.

Furthermore, the possible links between listed state-run firms and banks and China's

military industrial complex also requires comprehensive examination.

I might point out then--we'll be talking about this during the hearing--that Wall Street financial ratings for Chinese banks, for 13 Chinese banks which we have seen, give us some pause as to the intrinsic strength of those banks. None of those banks rise to even average international standards, and we'll be talking about that during the day today.

China's state-run enterprises and financial institutions are not transparent or accountable, making it nearly impossible to know the full extent of their assets and subsidiaries. Now that Congress has enacted comprehensive enhanced disclosure framework known as the Sarbanes-Oxley law, Chinese firms apparently have been bypassing the New York Stock Exchange and listing mainly in Hong Kong, London or Frankfurt.

Given the rush of Chinese IPOs, particularly to the Hong Kong Stock Exchange, the Hong Kong Stock Exchange financial authorities would

be wise to recognize the potential consequences of allowing Beijing-managed firms to acquire so much capital under their auspices, and there is some concern that these institutions are going to Hong Kong Stock Exchange with the lower regulation and standards as a way to bypass Sarbanes-Oxley. That's something that we need to discuss.

Taken together, all this suggests that China's need to finance its economic expansion and support its state-owned enterprises with U.S. investors' money demands the full attention of the United States government. I'd like to turn the podium over now to the Co-Chairman, Commissioner Mike Wessel, and then to my Vice Chairman Roger Robinson.

Commissioner Wessel.

HEARING CO-CHAIR WESSEL: Thank you, Chairman D'Amato, and thank you Vice Chairman Robinson for not only your co-chairing today's hearing but your leadership on this issue since the Commission's inception several years ago. It's your leadership that's helped raise real public attention

on this issue, and it's appreciated by us and by many others.

Since the Commission's last report in 2004, we've held ten hearings covering a range of topics on U.S.-China trade and security issues. Today's topic helps complete this picture of U.S.-China economic relations with the discussion of a topic that gets relatively little attention: the growing trend of Chinese firms raising capital in U.S. and global markets.

While it is certainly an appropriate step in China's economic development that its firms are now increasingly looking to global capital markets to raise funds, it is also appropriate for the U.S. government and the U.S. investors to want to better understand the nature of these listings.

This Commission has made clear in the past its concern about the lack of transparency of certain Chinese firms listing in the global capital markets. We've asked whether U.S. investors are sufficiently aware of the financial wherewithal of such firms and whether the U.S. government is

sufficiently aware of any military and weapons proliferation ties these firms may have as well as their impact on other vital security interests of the United States.

With regard to transparency, as the chairman noted just a moment ago, current U.S. securities laws such as Sarbanes-Oxley appear to have decreased the number of Chinese offerings in the U.S. capital markets due to concerns by the firms about the enhanced disclosure requirements for foreign registrants.

Today, we will discuss how this legislation has caused Chinese companies to list in Hong Kong or Tokyo rather than the United States.

Transparency concerns may be heightened with regard to the anticipated listings of major Chinese state-owned banks in the U.S. capital markets. I believe we need to draw attention to the level of due diligence performed by these banks and gain a handle on the true holdings in their loan portfolios.

Are they major sources of capital for Chinese military and defense firms? Moreover, Chinese state-owned banks have been the traditional sources of below market rate capital for China's state-owned industries serving, in my opinion, as a massive form of state subsidy unavailable to U.S. competitors.

Take, for example, the recent CNOOC bid for Unocal. To exceed Chevron's offer for Unocal, CNOOC received six billion in state-owned bank funding in addition to the seven billion in loans at below market or no interest rates from its state-owned parent company.

Deals such as this highlight how the nature of state-owned bank lending practices may be based more on governmental interests than true market forces.

As these banks list publicly, this behavior needs to be monitored and at the very least investors deserve complete disclosure of the non-market forces at work.

The forces that drove Congress to enact Sarbanes-Oxley are no less important here as we look at how to protect the investing public.

Our intention is not to propose unreasonable restrictions on the access of Chinese firms to U.S. capital markets. Our goal instead is to ensure that the U.S. government and U.S. investors have the most complete information possible on the financial standing and activities of Chinese firms listing in our capital markets. The proper functioning of our capital markets requires broad transparency of the listed entities. We should hold all listings to this important standard.

Thank you.

CHAIRMAN D'AMATO: Thank you very much, Commissioner Wessel. I'd like the podium over now to our Vice Chairman Roger Robinson who has probably more knowledge and experience in this particular issue, in my judgment, than anyone else I know of in this town or really in the country. So, with pleasure, I turn this over to Vice Chairman Robinson.

VICE CHAIRMAN ROBINSON: Well, thank you very much, Mr. Chairman. I'd like to join Chairman D'Amato and the co-chairman for today's hearing, Mike Wessel, in welcoming you to today's hearing, which, as you know, is entitled "China's Strategy and Objectives in Global Capital Markets."

As has already been mentioned, our focus today is on the cutting edge issue of China's presence in the global capital markets and the implications for U.S. investors, market regulators and more broadly U.S. security interests.

The next between financing and security is a topic of growing concern for both the legislative and executive branches of the U.S. government. This was recently highlighted in the House's overwhelming rejection of CNOOC's bid for Unocal as well as President Bush's June 29 Executive Order which freezes U.S. assets of weapons of mass destruction proliferators.

These developments are a wake-up call that increasing attention will be paid to the national security implications of Chinese and foreign

companies in U.S. markets including our financial markets.

In setting out our mandate, the Congress took a broad view of the economic and security issues associated with the U.S.-China relationship. Our charge is to examine, quote, "Chinese access to and use of United States capital markets," demonstrates congressional recognition that U.S. institutional and individual investors funding Chinese firms through our equity and debt markets has become a substantial component of the U.S.-China economic relationship.

Moreover, our mandate to evaluate whether existing disclosure and transparency requirements are adequate to identify for investors any Chinese firms conducting or involved in activities harmful to U.S. security interests points to congressional concern about the identities and operations of certain Chinese firms accessing our markets.

In December 2001, the Commission introduced this topic with a hearing that set out the enormous capital requirements of China over the next decade,

stemming in part from undercapitalized banks, its underfunded pension systems, and other social security obligations, and the importance that fundraising via the international capital markets will play in meeting these needs.

This hearing also established benchmark assessments of the amounts of money raised in the U.S. and the other international capital markets by Chinese enterprises and the predominance of state-owned enterprises among those approved by the Chinese government for overseas listings.

The Commission's April 2004 hearing on this topic broadened this initial assessment by looking at the corporate governance and transparency of Chinese firms listing abroad. The key focus was on how Chinese governance practices compare with Western norms and whether Chinese firms adequately disclose to international investors the nature of their financial and business operations worldwide including any ties to China's military and known weapons proliferators.

This year's hearing will focus primarily on how Chinese companies prepare for listings, the upcoming listings of Chinese banks, and the implications for U.S. investors and U.S. security interests of China's overall capital raising strategy.

Chinese firms preparing for initial public offerings in foreign markets generally undergo an extensive process of "window dressing," as it's called on Wall Street, to improve the appearance of their finances and operations. The extent to which these reforms are cosmetic versus genuine structural changes and the marketing strategy employed by Chinese firms in the U.S. capital markets will be explored by our first panel.

Mr. Howard Chao was to begin the panel, but due to a breakdown literally in his travel arrangements he'll not be able to join us until 3:30 this afternoon. He is a partner in charge of O'Melveny & Myers' Asia practice. During his 25 years of practice, he's been responsible for establishing O&M's China offices and was stationed

in Shanghai for some seven years, but we will repeat that introduction later this afternoon.

We do have with us Michael Geczi, Managing Director of The Torrenzano Group, who is an expert on how Chinese firms market themselves in U.S. capital markets. He has advised numerous Chinese firms on how to approach U.S. institutional and portfolio investors.

Robert G. DeLaMater, is a partner at Sullivan & Cromwell. He has worked on dozens of Chinese IPOs from 1997 to 2003, and was also managing partner of Sullivan's offices in Hong Kong and Tokyo.

Our second panel will provide an assessment of the concerns surrounding the listings of Chinese state-owned banks on global capital markets. Over the next year or two, several of China's preeminent state-owned banks, including the China Construction Bank and the Bank of China, are expected to list on the U.S. and other international capital markets and potentially raise as much as \$15 billion. These banks have been plagued by financial problems

including an extraordinary amount of non-performing loans and a lack of transparency.

We will hear from Professor Pieter Bottelier, Adjunct Professor at Johns Hopkins School of Advanced International Studies and Georgetown, and Professor Marshall W. Meyer, Professor of Management and Sociology at the University of Pennsylvania's Wharton School of Business.

Professor Bottelier will review the state of China's financial institutions and their attempts to reduce nonperforming loans. Professor Meyer has just returned from Beijing where he conducted research on how China seeks to list its financial institutions.

The third and final panel, as we just review the day here, will examine China's long-term strategy in global capital markets and the U.S. national security dimensions. Over the past year, Chinese firms have turned toward Hong Kong. In 2004, companies in Hong Kong raised 12 billion, up from 7.5 billion the year before.

By contrast, the New York Stock Exchange temporarily appears to have fallen from favor in the eyes of Chinese firms seeking to raise money in international capital markets, primarily as a result of the strengthened regulatory regimes required by the Sarbanes-Oxley law.

This dynamic begs the question: Are Chinese firms avoiding exchanges that require greater levels of disclosure, transparency, and corporate governance?

Solomon Tadesse, Assistant Professor of International Finance at the Moore School of Business at the University of South Carolina, and Donald Straszheim, President of Straszheim Global Advisors and formerly Chief Economist for Merrill Lynch, will provide an overview of Chinese strategies and objectives in global capital markets and their implications for U.S. investors.

Frank Gaffney, President of the Center for Security Policy and formerly the Acting Assistant Secretary of Defense for International Security Policy in the Reagan administration, will address

security concerns related to certain Chinese firms listing in the international capital markets.

The Commission remains to my knowledge the only U.S. government body systematically examining this emerging area of financial and security risk associated with the trading and listing of Chinese debt and equity offerings in the U.S. and other international capital markets.

With that introduction, I'd now like to turn to our first panelist, and if we could begin today with Mr. Geczi.

MR. GECZI: Good morning and thank you.

VICE CHAIRMAN ROBINSON: I would only add, sir, that the way that we typically proceed is that you would have some seven minutes or so for your presentation, and at which time the commissioners will have approximately five minutes each for our question and answer period. With that, thank you very much, if you'll proceed.

MR. GECZI: Understood. Thank you. Thank you. Good morning. My name is Michael Geczi, and I'm a managing director at The Torrenzano Group, a

New York based strategic communications consulting firm. I am pleased to be part of this morning's public hearing on China and the Global Capital Markets, and I thank the Commission for inviting me to participate.

My views on this important topic are shaped by a number of factors, the most prominent of which is the fact that while living in Hong Kong and working throughout the People's Republic of China between late 2000 and 2003, I regularly provided strategic communications counseling to companies based in the PRC.

This advice, which I've provided to state-owned enterprises as well as smaller entrepreneur-based companies, was designed to assist those companies in developing public profiles and corporate reputations as well as a level of market awareness that would be beneficial to them as they considered their various alternatives for raising capital in the West.

Ideally, the communications strategies would be appropriate irrespective of whether the

companies ultimately attempted to raise capital publicly or whether they were to seek a private investment.

Since returning to the U.S. in 2003, I have continued to focus on Asia Pacific in general and China specifically. Accordingly, I regularly discuss positioning strategies and tactics with PRC companies, their legal and financial advisors, and others involved in the global capital raising process.

I also conduct training sessions on media relations, investor relations and message development. These sessions all are intended to assist PRC companies in developing a profile in the West.

Moreover, I've conducted strategic training sessions for certain staff members of the Hong Kong Stock Exchange. My focus on China builds upon my earlier experiences, first as a financial journalist for 16 years, primarily with the Wall Street Journal and Business Week magazine, later as the head of Capital Markets Media Relations at Merrill Lynch,

and for the past 15 or so years as an outside communications consultant.

Over the past 12 years, my specialty has been developing and implementing cross-border communication strategies focusing first on the developed markets of Western Europe and then in the mid-1990s building an expertise in Russia and some of the republics formerly part of the Soviet Union, and then ultimately Asia Pacific.

The Russia experience in particular has been very helpful as a context for viewing the emerging PRC developments. There are some very meaningful similarities and differences when looking at how Russian and Chinese companies have approached corporate profile-building activities in the West. I will touch on these briefly in my remarks.

In your communication of August 2, 2005, you noted that the Commission is particularly interested in exploring five specific questions. I would be pleased to share with you some of my thoughts on each of those. Before I do, however, I would like to make a couple of affiliated comments

that might be useful as I move through my answers to your direct questions.

Irrespective of the questions or focus of interest, I believe there are several factors that are crucial to remember. First of all, when it comes to the topic of investing in China, it is imperative that we not lose sight of the fact that we are discussing a seller's market and not a buyer's market. As a result, all strategy regarding the marketing of issues or the positioning of companies is colored by the fact that demand sharply outweighs supply.

We are not talking about convincing an investor into buying something he or she does not want to buy. We are talking about letting a prospective investor who is already strongly inclined towards buying know that additional supply soon will be available. Therefore, I believe any look at the capital markets activities of PRC companies also must look at the demand side of the equation, that is the investors, with the same

degree of interest and concern as when we look at the supply side, the issuers themselves.

Stated another way, let me quote from the Organization for Economic Cooperation and Development, the OECD, which says: "Unfortunately, capital is rarely patient. In their constant search for investment opportunities, investors will not hesitate to take their money around the globe."

My second point is the following: Many of the questions addressed to this particular panel have gone to the issue of how PRC companies market their issues to investors in the West. While that obviously is an important issue, I believe it is equally important that we look at two other factors: one I just mentioned, which is the demand part of the equation. The second is that we must also remember that PRC companies also are being marketed to by Western advisory firms that help them negotiate the capital markets landscape.

Having said that, I now will address your specific questions. Your first question asked: How do Chinese firms market their equity and debt

issuances in the U.S. as compared to Hong Kong and other exchanges?

I believe this question can be answered in a number of ways. First of all, regarding the issue of marketing equity and debt issues, there is an important distinction worth noting, and that is the difference between marketing at the time of a public offering compared with ongoing marketing-- better known as investor relations--designed to support and enhance the stock price in open market trading. Obviously, the top line answer is as follows:

Given the precise nature of SEC guidelines, PRC companies market in the U.S. in exactly the same way as companies from other locations including companies in the U.S. They face the same rules and they face the same penalties.

I can tell you from personal experience about a client of mine that in 2002 had to withdraw its planned IPO in the U.S. because it ran afoul of the SEC's rules regarding quiet period preceding an actual offering. Obviously, the cost to this

company and its founders was high. The offering still hasn't taken place.

There also is an interesting sidebar story to this example: the excessive publicity occurred in Asia, not in the U.S., but nevertheless brought about the SEC's negative reaction.

Regarding your question on how the companies market, I believe the answer has important subpoints as PRC companies contemplating a public offering in the West face a unique set of challenges distinct from those of U.S. companies.

Ironically, the biggest challenge and the biggest opportunity for PRC companies generally can be described by the same three words: "the China story."

What do I mean by that? I mean that Western investors are drawn to PRC stocks exactly because they are from China and therefore possess all the explosive growth characteristics one associates with an economy that is growing at eight or nine percent annually.

Conversely, the biggest cautionary advice that one could give a prospective investor in PRC equities is that these stocks possess all the explosive growth characteristics that one associates with a market bubble, and that the stock market's reaction probably is going to hit each end of the spectrum.

The potential reward and the potential risk are both at the top of the list for prospective investors, but because of market multiples, many investors view the risk as more than acceptable given the potential reward. The risk after all is fixed; the reward is seen as being limitless.

Last week's noteworthy IPO by Baidu illustrates this point perfectly. As you know, Baidu's shares rose more 350 percent in their first day of trading on the Nasdaq Stock Market. They have since fallen back, but remain significantly above their offering price.

Clearly, Baidu's founder and other select early investors in this company stand to make a great deal of money. On paper, they already have.

But this wealth-building isn't only occurring in the PRC. California-based Google, which owns 2.6 percent of Baidu, is part of the crowd. So are a large number of U.S. institutional investors that were fortunate enough to acquire Baidu in the offering.

It is worth noting that Baidu's two founders are veterans of U.S. technology companies and Baidu's top competitor, a company by the name of 3721.com was bought in 2003 by Yahoo. As you also know, there currently are media reports this week that Yahoo will be trying to acquire 35 percent of another PRC company, Alibaba.com, and e-commerce company, for \$1 billion.

Now, according to the media reports that accompanied Baidu's offering, the investment attraction for most investors was that Baidu represents the China story, the combination of technology, economic growth, and enormous potential consumer demand. It is, in fact, the quintessential China story.

If you read the same articles, you will see that almost no one is bold enough to predict that Baidu's share price will remain at its currently lofty level. Why not? The same reason. It is the quintessential China story.

Bottom line, to me the issue isn't how PRC companies are marketing themselves; it is how investors are investing. It goes back to the OECD statement that I read earlier: "Capital is rarely patient."

I also have a second point regarding this question of how PRC companies market themselves in the U.S. vis-a-vis other exchanges. Given the globalization of world markets over the past decade, the issue of whether a PRC stock is listed in the U.S. or in Hong Kong has gotten very close to becoming irrelevant. The fact is U.S.-based institutional investors do not limit their investments to shares listed only on U.S. exchanges.

Regarding your second question: Do Chinese firms market their equity and debt issuances

differently to individual and institutional investors?

Again, the answer depends. The IPO market in the U.S., as you all know, is heavily geared towards institutional investors. And individuals traditionally have had a difficult time gaining access to the so-called "hot new issues." The pros and cons of this approach obviously have been debated and documented in the past, and there have been interesting and important steps taken to address them.

However, given this reality about IPOs in the U.S., the fact is that marketing of PRC stocks to U.S. audiences is very much an exercise in creating institutional demand. It is rarely about reaching the average retail investor. Generating demand at the institutional level is achieved through SEC-regulated road shows and by non-regulated word of mouth. It is the same process for PRC companies as it is for companies in Massachusetts or Florida or Montana.

However, within the rules of the SEC, there is opportunity for positioning, especially in the official prospectus and in the road show presentations. In those communications, PRC companies--like companies everywhere--are strongly counseled by their advisors to emphasize those key messages that best shape the company's prospects and, conversely, best address the concerns that are on the part of the possible investors.

Ideally, these messages are designed to connect the company's prospects to the powerful dynamics of the PRC economy. One major message that regularly is utilized and proves very effective goes to the issue of building the nation's infrastructure. This has been especially important for energy and telecommunications issues that benefit from that initiative.

In last week's Baidu example, the key message, as I said earlier, was tying the company's prospects to the PRC's massive population. As a result, here are some of the positive themes that were emphasized to investors: second largest Web

site in China; seventh largest Web site in the world; providing users with access to more than 690 million Web pages, 80 million image files and ten million multi-media files; establishing relationships with more than 76,000 third-party Web sites.

Now, as important as these messages were, there also was the powerful message that Baidu had Google as an investor. In fact, you will see that Baidu regularly was referred to in the media as the "Chinese Google" in much of the lead-up to the offering.

Back in Asia meanwhile, especially in Hong Kong and Shanghai, the story is very different. Although there is a significant institutional investor base in those major markets, issuers put a much greater priority on retail investors, and marketing strategies are much more geared toward reaching the "mom and pop" investors.

Hong Kong, in particular, is filled with stories about lengthy lines of individuals extending and wrapping around city blocks as they waited

patiently in line to buy a small piece of a new stock issue.

Your next question: What are the most significant expected listings?

My understanding is that several significant offerings are expected in the near to mid-term. Air China, for instance, is expected to attempt a listing possibly in the amount of \$500 million early next year.

Other noteworthy listings probably will be the largest state-owned banks, as you've already mentioned. The degree to which these institutions are able to clean up their balance sheets and then accurately articulate progress in doing so to the investing public will be interesting to watch. The Bank of China, the country's second-largest lender, has made progress in lowering its problem loans ratio, heeding a government prerequisite for proceeding with its initial public offering.

There is also an interesting and important emerging development relating to the way the large banks are positioning themselves for their listings.

They're attempting to enhance their attractiveness by taking in well known Western companies as investors prior to the IPO process. This is exactly the same model I mentioned earlier in referring to the Google investment in Baidu.

Bank of China, for instance, reportedly is negotiating with several potential investors including Royal Bank of Scotland, UBS and the Asian Development Bank. The Industrial and Commercial Bank of China, the PRC's largest lender, is said to be in talks with a variety of companies--among them are American Express and Goldman Sachs--to become investors prior to going public after 2006.

The goal not only is to have the better known company's credibility rub off on them, it is to improve their loan books and to better compete with overseas lenders such as Citigroup which has extensive operations in that part of the world.

Industrial and Commercial Bank is said to be seeking to raise as much as \$10 billion, and then there is China Construction Bank, the nation's third largest lender. In June 2005, Bank of America

announced that it would inject \$3 billion into China Construction Bank, taking an ownership stake of about nine percent, the largest investment by a foreign lender in the PRC.

And it was reported this week that HSBC would like to increase its current 19.9 percent stake in Bank of Communications.

It is important to note that these real and prospective investments by Western financial institutions do not represent a hands-off approach to the market. Says one money manager in a recent article: "Taking a strategic stake will provide the overseas investors with a launching pad into China's banking market which still is not fully deregulated."

Your fourth question: How do Chinese firms market themselves differently than firms from other countries?

PRC companies, of course, market themselves differently than firms from other countries. The same can be said for companies based in Eastern Europe, companies based in Latin America, companies

based in the European Union, and companies representing various industries and regions in the U.S.

Raising capital requires that companies position themselves in a way that addresses the key questions on the mind of the prospective investors. We all know many of these questions as they have to do with forecasts for sales and profitability and for the likelihood and magnitude of growth in both of those categories.

As I have discussed this issue with PRC companies in the past, the issue of message development and corporate positioning always includes the following issues: the issue of the buying power of the PRC's consumer base; the fact that they have a large and growing educated and skilled workforce; the impact of the WTO; the impact of the improving infrastructure; what is the level of government support to the companies; and the ease of entry for other companies.

VICE CHAIRMAN ROBINSON: Excuse me. We'll need to wrap up soon, if you don't mind.

MR. GECZI: I'm going to, yeah.

VICE CHAIRMAN ROBINSON: Thanks.

MR. GECZI: Additionally, our discussions have always hit on the fact that companies need to address these key questions that have to do with risks such as geopolitical risk, data risk related party risk and the rule of law risk.

Finally, on your fifth question about transparency and corporate governance, I'm not the attorney at this table, so I will let the attorney talk about that. But I will say that there seems to be in the capital markets right now the ability to differentiate between some of the stronger companies and some of the not-so-strong companies, those that are doing better and those that aren't.

The other thing I will do is just briefly touch back on the Russian example, and I can tell you in the mid-to-late '90s, the issue of corporate governance gained some traction with Russian companies and it was very much used as a public relations tool. In fact, it probably was coopted by many of them as a public relations tool, and at this

point I don't see Chinese companies going down the same path.

Since you want me to wrap up, I will wrap up. I thank you very much, and I appreciate your interest.

VICE CHAIRMAN ROBINSON: Well, thank you very much, Mr. Geczi. I would just say that your full statement will be included in the record of these hearings.

With that, Mr. DeLaMater.

MR. DeLaMATER: Thank you. Mr. Chairman and members of the Commission, thank you very much for the opportunity to be with you here today. As is well known, China has assumed an important role but as a user and more recently as a supplier of capital on a global scale.

As part of your mandate to review crucial aspects of the U.S-China relationship, the Commission has an important role to play in helping to ensure that the United States retains a leading position among the world's capital markets, given the essential role played by these markets in

providing investment opportunities for American investors and in supplying capital to businesses that provide jobs and economic opportunities to American workers in their communities.

Your diligence in reviewing developments in this area is vital and I wish you success in your efforts.

I have worked for nearly 20 years as a corporate and securities lawyer and much of my practice has dealt with cross-border securities offerings. My responsibilities in my firm's offices in Tokyo and Hong Kong have enabled me to observe the approaches to U.S. capital markets taken by companies based in China.

Over the past decade, there has been an interesting shift in the practice of these issuers in accessing U.S. markets, a change that has implications for the position of the United States as the world's principal capital market. During the 1990s, there was a sharp rise in securities offerings in the United States by foreign issuers of all nationalities. China was an active participant

in these trends and many companies organized in China or having their principal operations there obtained listings of their shares on the New York Stock Exchange, or Nasdaq, and thereby became SEC reporting issuers subject to the full range of U.S. reporting and disclosure obligations for foreign issuers.

However, the level of interest among foreign companies enlisting in the United States has changed dramatically in recent years. The significant stock price declines beginning in March 2000 led to reduced interest on the part of U.S. retail investors in investing in initial public offerings.

Also, the enactment of the Sarbanes-Oxley Act in 2002 inhibited many foreign companies from seeking a listing in the United States, not only because of its significant requirements relating to board composition, corporate governance and internal control review, but also due to concerns about what other new U.S. regulatory requirements might be imposed upon short notice in the future.

Moreover, Chinese companies listing on the Hong Kong Stock Exchange increasingly believe that there may be limited value in seeking another international listing in light of the apparent willingness of investors around the globe to invest in Chinese companies listed only in Hong Kong.

Developments in other markets have also contributed to issuers seeking to diversify the markets in which they raise capital and, as a result, to less reliance on the United States. One important feature of some of the recent large Chinese privatizations has been what is known as the public offer without listing, or POWL, in Japan.

In some of these offerings, the amount of demand in Japan reportedly has exceeded a few billion dollars and may have accounted for a larger proportion of the offering than that sold in the United States.

Another development has been the increased effort by the London Stock Exchange to solicit listings by Chinese companies by marketing London as an alternative to the increased governance

requirements and the risk of securities class action lawsuits claimed to be inherent in listing in New York.

Air China last year was convinced to list its shares in London rather than in New York. In recent years, those Chinese companies that have listed in the United States have principally been smaller technology-oriented companies seeking to list on Nasdaq. A very well known current example is Baidu.com, famous for rising nearly 400 percent on its opening day of trading last Friday.

But these are not state-owned enterprises. Their principal shareholders are individual founders and management as well as a number of U.S.-based venture capital and private equity funds. Far from being methods for funding the Chinese government, these offerings are rewarding the entrepreneurs who built the company and the early investors, often U.S. investors, who finance them.

In contrast, since 2002, only a handful of Chinese state-owned enterprises have sought U.S. listings and SEC registered IPOs. The initial

public offerings and New York listings by ChinaNet.com in 2004 and China Life in 2003 echoed the Chinese privatizations that commonly were listed on the New York Stock Exchange through 2002.

However, other recent large initial public offerings by state-owned enterprises have listed only in Hong Kong or London and have gained access to U.S. investors by means of a private placement to institutional investors pursuant to Rule 144A. The ability to raise billions of dollars from offerings to U.S. investors by using Rule 144A has led many foreign issuers to conclude that there is no need for the incremental retail demand afforded by SEC registration.

In other words, when even the largest security offerings can be completed by Chinese and other foreign issuers without SEC registration, to U.S. investors who are willing to accept a foreign market such as the Hong Kong Stock Exchange as the sole listed market trading venue, foreign issuers are less willing to incur the costs and ongoing requirements of SEC registration.

Having spent my entire professional career as a U.S. securities lawyer, my purpose today is not by any means to criticize the Sarbanes-Oxley Act or the other elements of the U.S. securities regulatory scheme that apply to foreign issuers. Those regulations and the manner in which they have been administered by the SEC and its highly professional staff historically have made accommodations that enhance the attractiveness of the U.S. capital markets to foreign issuers by taking into account their specific or unusual needs compared with U.S. domestic issuers.

It should be noted that with the exception of Canada, U.S. federal securities regulation has generally not made distinctions among foreign issuers on the basis of nationality, but instead has treated all foreign issuers in the same manner.

My point, however, is to emphasize the importance of any single nation's capital market to the global capital market is not something that is fixed and it can fluctuate with changes in relative

economic development, changes in regulation and many other factors.

One instructive example is that of Japan, which during the 1980s enjoyed an economic boom that attracted 127 foreign companies to list on the Tokyo Stock Exchange. Today, after over a decade of economic difficulty and many de-listings, the number of foreign companies listed on the Tokyo Stock Exchange has fallen by 80 percent.

This has occurred despite the strong increase in recent years of capital raisings in Japan through the mechanism of the public offer without listing.

Everyday investors in the United States buy securities of foreign companies that are not listed in this country. As the United States, like most developed nations, imposes no capital controls on money invested abroad. This is an age of highly mobile capital in which substantial sums can be raised without the need for foreign companies to list their securities in the market in which investors are located.

As many commentators including Chairman Greenspan have noted, there appears to be a global glut of savings and China itself is a major supplier of capital to the United States as a purchaser of U.S. Treasury securities. This global savings glut leads to the phenomenon that those who seek capital are readily able to find it. And those who wish to have attractive investment opportunities may need to compete in order to do so.

There are a number of disadvantages for the United States if it is not the overseas listing venue of choice for Chinese and other foreign companies. Most importantly, to the extent that global accounting, governance, and disclosure requirements have not fully converged, the United States loses its ability to apply its own higher requirements if companies do not choose to list their securities in this country.

The desire to diversify investments, which is one of the tenets of modern portfolio management, will strongly encourage U.S. investors to invest in foreign companies, and it is certainly better for

our investors if those companies are as engaged as possible in the U.S. securities regulatory and reporting regime.

I suggest that it is vitally in the interest of the United States that our capital markets regulation be shaped and administered in a way that encourages access to U.S. markets by foreign issuers including Chinese issuers while at the same time protecting U.S. investors.

Many of the most attractive investment opportunities in the world today are in Asia in general and China in particular, always assuming that our regulations meet the threshold requirement to provide appropriate levels of investor protection. We would not be serving the interests of the millions of Americans who depend upon the investment performance of their pension managers, insurance companies, mutual funds and financial advisors if we lead Chinese companies to avoid U.S. capital markets in favor of listings in London, Japanese retail offerings, or other offerings in Europe and the international markets.

As you noted, I've submitted a written statement that extend these remarks, and I'd be happy to take any questions, and I thank you again for the opportunity to be here today.

VICE CHAIRMAN ROBINSON: Thank you very much, Mr. DeLaMater. With that, I'd like to move to questions and answers from my fellow commissioners, beginning with Chairman D'Amato.

CHAIRMAN D'AMATO: Thank you very much Vice Chairman Robinson, and I want to thank both of you for very, very interesting testimony. And I think it raises a number of issues. I'm mainly concerned here that it looks like, and I'll ask you whether this is valid, that there is a movement away from the American markets because, of course, Sarbanes-Oxley provides a higher standard, which bothers me, because it looks like we're going to have a lot of Chinese IPOs. We're going to have a lot of Chinese banks looking for money. We're told that they don't need the money; they need extra money, walking around money.

We're told by the IMF that it's icing on the cake money. While billions and billions of dollars from American investors are icing on the cake for Chinese banks, the question is what are the standards of disclosure and transparency for investor protection that are going to be involved here?

We've just gone through a period of the high tech bubble. We all remember that. Many, many Americans, billions and billions of dollars were lost in that extravagant rush and stampede to what looked like the nirvana of riches with high tech bubble. Are we on the verge of a China bubble?

You talk about, Mr. Geczi, you talked about the Bank of China and the China Construction Bank, we have a Wall Street rating firm who has rated these banks. The ratings go from A, B, C, D, to E. That's the regular ratings. The average rating for banks in the international market is C plus. No China bank even gets a C minus. Bank of China gets a D minus. The China Construction Bank gets an E plus. E plus means you better watch out.

So I'm wondering here about this bubble. You say there's no difference--I want to ask you--there's no difference between listing on the Hong Kong Exchange and the New York Stock Exchange. I don't understand that statement because it seems to me that they're going to the Hong Kong Exchange to evade the American standard, and then through the trap door, I guess, of what you call the 144A private placement, investors can go and invest in those placements without complying or having the offerer to comply with American higher standards.

So I'm just worried about the question of whether or not we're going to a China bubble where we're going to have a lot of puffery and the question of value for the American investor is of question here. Do you see that this rush of IPOs leads to this kind of concern that we may end up with some kind of a bubble that could put investor investments at some risk? And I'd like each of you to address that if you would. Go ahead.

MR. DeLaMATER: Well, there is no question there are certainly fads and fashions in the

investment world. Certain types of investments come in and out of fashion, and it is, I think, clear that one of the investment phenomena of our age and of this time is interest in foreign investments in general, Asia more particularly, and China most particularly, for all the reasons that are so widely discussed--population, rapid economic growth and so forth.

I think, however, it's also important to appreciate that securities offerings in this country are highly regulated regardless of who the issuers are. There is an elaborate scheme, as all of you know, for SEC registration. All foreign issuers are required to comply with that if they wish to sell securities publicly. Even in the 144A context, it is the practice of the major participants in that market, the major intermediaries, such as investment banking firms, to insist upon essentially the same type of disclosure in an offering circular for a 144A offering as exists in a prospectus for an SEC registered offering.

Some of the main reasons for choosing the 144A private placement route as opposed to a registered offering relate to some of the more technical requirements of the disclosure forms which may be more difficult for foreign companies to compile, but which do not affect in a material way the total mix of information that's being provided.

Another factor is the timing that can be required in preparing a registered offering and going through the registration review process. Sometimes foreign offerings, if they need to be coordinated with a simultaneous listing in a local market may find it difficult to meet the timing requirements of the U.S. process.

And I think finally, the Sarbanes-Oxley Act has irritated foreign issuers most because it in many respects goes beyond what has historically been the purview of U.S. federal securities regulation. Historically, U.S. federal regulation was directed at disclosure and requiring full disclosure with Justice Douglas' statement that sunshine was the best disinfectant.

What many of the provisions of the Sarbanes-Oxley Act do, however, is go beyond disclosure to require certain types of governance arrangements by listed firms such as a certain number of independent directors, independent directors comprising the audit committee, certain relationships between the board, the audit committee, outside auditors, and those are things which many foreign companies found difficult to comply with, not because they resisted the thrust, the general idea of it, but because the specific implementation of it was contrary to their local practices.

Another example which illustrates how the act took essentially no real account of foreign issuers and their unique needs was the bar on loans to executive officers and directors. As I'm sure you know, U.S. banks were specifically exempted but foreign banks were not, and so that led to the anomalous situation that a foreign bank listed in the United States would be unable to extend a home mortgage loan to one of its own executive officers

and directors, and it's things like that, and I should hasten to add that anomaly was corrected by SEC action relatively promptly, but it's things like that that have led many foreign issuers to believe that there is a regulatory risk in listing in this country that goes beyond disclosure requirements and goes into some of the implementation of governance and other requirements.

MR. GECZI: Yes, thank you. I think I just have three points on this particular issue. On Sarbanes-Oxley and Chinese issuers seeking to avoid the high hurdles of Sarbanes-Oxley, I think it's important to point out that there's a companion activity going on with foreign listed companies in this country that are thinking about withdrawing their listing because of the onerous hurdle. So this is not a situation of Chinese companies trying to avoid something. It's a situation of companies that are already listed, foreign companies that are already listed thinking that the New York Stock Exchange or the U.S. type listing is no longer in their best interests.

Vis-a-vis New York Stock Exchange listing versus Hong Kong listing, I can tell you from personal experience in talking to Chinese companies, at least it's my sense that those decisions are often made as to at what point in the development the company is. These companies would love to list in New York; they would love to have the prestige. They may not be ready for that, but they may have the capital needs at that particular point. Hong Kong presents an alternative for them for whatever point in the maturation their company is in.

I think every conversation I've ever heard with a prospective issuer, they would ideally love to be able to list in the U.S., but if the company is not sufficiently mature, if the books aren't sufficiently worked out properly yet, if they haven't built their business enough, Hong Kong becomes a real alternative for them because it's where their need and the capital supply can come together.

And on the third issue, on the Chinese banks in particular and their ratings, which I don't

think anybody would dispute, and I certainly agree, it strikes me that if capital markets investors are going to invest in companies with ratings like that, then they have no one to blame but themselves. I think if banks have ratings like that, they're probably not going to succeed and that suggests to me that the capital market works as a self-governing marketplace and it does what it needs to do.

CHAIRMAN D'AMATO: Thank you very much. I hope you're right in what you just said about the Chinese banks, but I detect kind of a stampede here. What I'm worried about, I think what we're worried about, is defending some standards as a result of tremendous loss of value to average American investors as a result of the high tech bubble. We're still close to that experience and erring on the side of higher standards I think is what is driving us.

Thank you very much.

VICE CHAIRMAN ROBINSON: Thank you, Chairman D'Amato. Co-Chairman Wessel.

HEARING CO-CHAIR WESSEL: Thank you and thank you both for being here. It's very important testimony, very interesting, and Mr. Geczi, I'd like to ask you a question with a quick answer, if I can, and understanding that strategic messaging is a very important industry in this country and certainly in this town. It seems to me that your comments about the CNOOC-Unocal deal were a problem of messaging more than anything else, and I certainly believe that the Chinese government's stepping in and saying don't mess with this transaction probably did more damage than anything else to the view that this was, in fact, not a government-sponsored or government-directed investment. What are your views on that?

MR. GECZI: I think that was step two. I think step one was the perfect defense strategy that was put together, which was to raise the flag.

HEARING CO-CHAIR WESSEL: To raise?

CHAIRMAN D'AMATO: To raise the American flag?

MR. GECZI: To raise the American flag.

HEARING CO-CHAIR WESSEL: Raise the American flag.

MR. GECZI: That was the perfect defense strategy. It worked very effectively. China then might have made a mistake with their comment, but I think that played out just the way one would expect it to play out and it was done very, very well.

HEARING CO-CHAIR WESSEL: By one side?

MR. GECZI: Absolutely.

HEARING CO-CHAIR WESSEL: By one side. Let me turn and have both of you respond. It seems that what we're also talking about here is another component of the globalization strategy or the globalization issue. It seems that we're looking at some Chinese companies, maybe others, but our focus is on China, who may be shopping the globe for the weakest disclosure standards that give them the requisite amount of capital they need to fill their needs. Certainly, the crown jewel of capitalism is the New York Stock Exchange for the imprint that gives, but Sarbanes-Oxley has deterred some from coming there now.

Yet I think our ultimate goal should be upward harmonization in standards rather than diminution in those standards. When Bank of America that's now purchased 9.1 percent of the Chinese Bank comes for its annual meeting next year, should we expect that their proxy statement will give us some of the disclosure tools that we want to understand what the nature is of their investment since that Bank has yet to come to the U.S. capital markets?

MR. DeLaMATER: Well, I wouldn't presume to speak for them.

HEARING CO-CHAIR WESSEL: Speaking from a legal perspective, a 9.1 percent, multi-billion, a significant investment, that's a material event for the Bank of America; correct?

MR. DeLaMATER: Well, I'm not sure. It's a very large institution.

HEARING CO-CHAIR WESSEL: Understand, and it's based on capital standards, et cetera. Assuming it's material, would we be able to gain some disclosure tools as a result of that, meaning that if the Chinese companies aren't going to come

to the U.S. market, they're going to go Tokyo or Hong Kong, do we have the secondary review tool now that for U.S. companies, U.S. hedge funds, to the extent that they're disclosing in any way, and I know most aren't, CalPERS, all the other institutional investors?

MR. DeLaMATER: Well, if I could just go perhaps to the premise of your question, which is that foreign requirements are necessarily lower than those in the United States, or that the Hong Kong Stock Exchange in particular, the suggestion is that that is the easy way out for these companies, and I don't think that is actually the case. The Hong Kong Stock Exchange has very detailed disclosure requirements.

HEARING CO-CHAIR WESSEL: Are they as stringent as New York Stock Exchange?

MR. DeLaMATER: Well, I'll give you one interesting difference between the two regimes. The Hong Kong Stock Exchange will not list a company unless it meets a multi-year track record of profitability. So many high tech companies which by

nature of their operations, whether its biotech or internet related, may never have achieved profitability, the Hong Kong Stock Exchange will not list them, so that's why we see so many Nasdaq listings by these companies. They come to this country because the fact that they've never turned a profit doesn't prevent them from listing here.

Now, there are many good reasons for that. Obviously, in a developing industry--biotech is an excellent example--many of the leaders of biotechnology today did their IPOs and raised substantial capital without profits. Many mainstays of American life today--Amazon, other companies--were not profitable when they did their IPOs.

I think commentators would say that that, however, is a sign of the strength of American capitalism, that it can recognize an opportunity even when a company may not be profitable, when it may be going through very difficult times, or when it's going through a transition from one type of operation to another.

I think that is something that relates very much to the Chinese financial sector. I think even commentators closest to this and even the Chinese authorities themselves would recognize that the Chinese financial sector historically was not operated on strictly commercial lines and that there was a substantial element of policy-based operation.

That is something that they're in the process of changing and seeking to divide policy lending from commercial lending and have those conducted in separate institutions. It's not something that happens overnight. And part of the reason for seeking the substantial investments from foreign financial institutions is to assist in that transition to a modern commercial credit culture with risk management, checks and balances and proper documentation and so forth that we associate with sound banking practice.

But that is a long process and that's why these institutions have been working on this for the last several years. A lot of publicity is being directed at this now, but these are changes that

have been in the works for several years and will continue.

HEARING CO-CHAIR WESSEL: Thank you.

VICE CHAIRMAN ROBINSON: Yes, thank you, co-chairman. Commissioner Wortzel.

COMMISSIONER WORTZEL: Gentlemen, thank you for taking the time to appear today. My questions will relate to what you characterized as maturation and corporate governance. As state-owned firms go public in China, what percentage of ownership and control does the PRC government retain and taking Air China as an example--it's been mentioned by both of you--how was that corporate board restructured? Can you characterize how international or foreign-board members are chosen? And could you also discuss how those companies are restructured?

For instance, when Air China Limited listed in Hong Kong in I think it was 2004, what's the relationship between Air China Limited, you know, as in Hong Kong and Air China up there in Beijing?

MR. DeLaMATER: Well, I think that for Chinese companies, they have followed the pattern

with respect to their privatizations that's been followed by privatizations around the world. The privatization movement in the modern era really got started in the early '80s with the UK, progressed through a number of European countries and now a number of Asian countries, and it's followed a fairly similar pattern in that the government begins by selling off a portion of its stake but retaining a majority interest.

In many of the European privatizations, the government retained a so-called "golden share," which would allow it to control certain aspects of the company's operations, even if it sold down below a majority of the total equity. And so the model of those privatizations was very much one of maintaining government control over key aspects of the company. That's not something interestingly that the Chinese have ever done. They have not retained golden shares in these companies, and the pattern is expected to be that over time they would continue to sell down their stakes in these

companies, and the companies would become more and more privatized.

Just an interesting document in greater China and Asia which is that the government of Taiwan just in the last few days completed the sale of an additional stake in Chunghwa Telecom, taking its stake below 50 percent and allowing it to declare that company privatized.

And so this is a multi-year process, and it's affected substantially by capital market developments and the receptivity of markets to taking these large equity stakes. The government of Australia selling down its stake in Telstra which is the former monopoly telecom operator has taken many years to get to a point where it believes it could sell below the majority level. And so it's not something that the government itself necessarily has control over.

With respect to board composition, generally the board contains some persons appointed by the government with a view toward monitoring the company and taking into account the interests of the

majority shareholder as would be the case in any such situation. But there are also independent directors and they are chosen in a variety of ways, but there is an increasing emphasis on choosing persons of standing and credibility who can be looked to by international investors as people who will be more sophisticated in financial matters and who will look out for the interest of public investors.

I'm sure you saw the publicity surrounding the CNOOC bid and the fact that one of the independent directors there was cited as having been influential in the decision whether or not to go ahead with that transaction and the terms on which it would proceed, and so I think it is increasingly the case that independent directors of these companies are persons of standing and experience and they're given influence in the board's deliberations.

MR. GECZI: I would just briefly add to that, that every experience I had with PRC companies but especially with the SOEs, the very first issue

had to do with seeking out this person of standing and the companion issue was what was the best way to aspire to global best practices in doing these kinds of things. And that was always the first conversation I would ever have with somebody initiated on their behalf.

VICE CHAIRMAN ROBINSON: Commissioner Dreyer.

COMMISSIONER TEUFEL DREYER: Thank you both for coming. Baidu's headquarters are, I believe, and also their business operations are in China, but it's incorporated in the Cayman Islands; is that correct?

MR. DeLaMATER: That's correct.

COMMISSIONER TEUFEL DREYER: Yeah. And I notice or we have noticed as a group from other information that the Cayman Islands is becoming more and more important as a financial center for Chinese enterprises. Could you characterize how prevalent it is for Chinese operations to headquarter themselves in--I mean to incorporate themselves into the Cayman Islands, and what are the consequences of

that for their independence from the Chinese government and for taxation purposes on the part of the Chinese central government?

MR. DeLaMATER: Well, this is an approach that was taken really right from the beginning during the early '90s when Chinese enterprises or enterprises with their principal business operations in China began to seek to do IPOs and list in the United States. A number of those early transactions were companies organized in Bermuda or the Cayman Islands that controlled joint venture interests or operations in China.

And there were a few reasons for that including the fact that by doing so, it would be possible to reduce the delays or requirements of regulatory approval within China that might attend such a listing process. Also, there was an attempt to try to impress investors with the fact that these were companies that would be operated according to Western governance standards. Bermuda law or Cayman law and corporate governance was thought to be widely understood and recognized by the

international investment community. And at that time, in the early '90s, there was concern that perhaps Chinese corporate law had not developed to the point where it would be accepted by the international investment community.

And so many of the early listings were done by using those jurisdictions, and it's continued to be the case that for a number of private companies that operate in China. There are a number of reasons for using an offshore jurisdiction that again relate to smoother regulatory processes, absence of corporate tax in jurisdictions like the Cayman Islands and Bermuda, and--

COMMISSIONER TEUFEL DREYER: Excuse me. So you're saying that the Chinese central government then gets less tax revenue if the company is incorporated in the Cayman Islands; is that correct?

MR. DeLaMATER: Well, no, the business operations are conducted in China and so tax revenues, the tax regime that applies to the conduct of business in China, remains the same. But the difference is that at the corporate level when

shares are sold and capital gains tax might be generated, those jurisdictions don't levee taxes on capital gains.

COMMISSIONER TEUFEL DREYER: So who is losing the revenue then?

MR. DeLaMATER: Well, the country that might otherwise have been chosen. It might have been the United States. It might have been China. It might have been anywhere. But choosing a jurisdiction in which there's no tax on capital gains is something that many entrepreneurs try to do.

COMMISSIONER TEUFEL DREYER: Sure, I understand that. So it is the country that like the United States or France or wherever that is losing the money. The Chinese tax man is not losing the money; is that what you're saying?

MR. DeLaMATER: Well, I guess what I'd say is that in this instance, perhaps the U.S. and China see the situation in the same way, and that it might be more desirable from a fiscal perspective to have more companies organized in one's own country rather

than in an offshore jurisdiction. But I don't think it's the case that one could say that tax revenues are really lost in any practical way.

COMMISSIONER TEUFEL DREYER: And what about the independence from the Chinese central government of a company that is incorporated in the Cayman Islands or some other offshore place?

MR. DeLaMATER: Well, I suppose nominally one might say that that company is beyond the reach of the country where the operations are being conducted, in this case China, but still because the business operations, all the revenues, are being generated in China, there is still a wide scope for these companies to be regulated by China.

COMMISSIONER TEUFEL DREYER: Mr. Geczi, have you any thoughts on that?

MR. GECZI: I think just a couple of points. I think the Cayman type listing in the early days would enable the companies on the positioning standpoint to be able to address one of the concerns of investors, which is rule of law because it provided an adequate answer for rule of

law, and I think on this latter point, and I think the independence from the PRC government, I think it's important to note that this is the listed entity that's--

COMMISSIONER TEUFEL DREYER: This is what?

MR. GECZI: The listed entity that's based in the Cayman's, and as Bob said, the operations are still going on in the PRC. And there's a distinction there.

COMMISSIONER TEUFEL DREYER: Thank you.

VICE CHAIRMAN ROBINSON: Commissioner Reinsch.

COMMISSIONER REINSCH: Thank you. Welcome to you both. It's awfully good to have witnesses who really know something about the field, and I appreciate your sharing your expertise with us. Listening to it and looking at your statements, I've sort of come away with two general conclusions which I'd like you to either validate or disagree with.

One is that in an era of surplus capital, issuers have lots of choices as to where they're going to go, and they're going to seek out those

locations that either most meet their needs or might be those that have the least onerous requirements or whatever. But the cards seem to be held by the seller and not the buyer.

The second thing that I come away with is that it sounds from what you're both saying that the Chinese are neither that different from anybody else in terms of how they behave as far as listings and looking for listings, nor are they different from anybody else in terms of how they're treated by the securities authorities in wherever they end up being listed.

Is that a correct conclusion from what you've been saying?

MR. GECZI: Well, I mean that's my perspective. I think the marketplace treats them the same way and there are those in the marketplace that understand what's going on in China and there are those that do not, and some of those people are going to do very well and some of them aren't going to do very well, but to me that's the marketplace.

But my experience with Chinese companies, whether they're entrepreneurial companies or SOEs, was very much that they wanted to be part of this global marketplace, they wanted to aspire to best practices, they wanted to have Western advisors come in and help teach them and teach their people and learn because they knew they had a long way to go on the learning curve.

Does that mean that in an SOE there isn't still remnants of the government in there? No, it doesn't mean that at all. But it means that there was an intention to try and do things in a way and to meet the best practices in the world and to do it in a way that is consistent with the way everybody else has to act.

COMMISSIONER REINSCH: Mr. DeLaMater?

MR. DeLaMATER: Well, I think that it's economically rational for any business to try to conduct its affairs in a way that results in the most efficient operations and very often that leads any business, including American businesses, to try to operate in ways that minimize their taxes, that

minimize regulatory delays or hurdles to efficient operations, and so the fact that Chinese companies take a hard look at different listing venues and try to assess which ones meet their needs and which ones don't is evidence of behaving like capitalists.

And it's the same thing that any business anywhere engages in, but having said that, I think there is a strong feeling among these companies that they wish to be perceived as following international best practices, and that they take advice from advisors and they talk to institutional investors around the globe about what are regarded as best practices and take that into account.

COMMISSIONER REINSCH: Thank you. The fact that they're turning out to be capitalists is a point that's been made here frequently by other witnesses and it certainly seems to be true.

Now, Mr. DeLaMater, your written statement had just a wonderful paragraph that unfortunately you truncated in your oral presentation, and that's the one that began with--it talked about the disadvantages to the United States if listings are

elsewhere and you provided only a couple of the longer list of disadvantages that you cited here, and I'm glad to hear from the chairman that the full statement will be in the record.

Without asking you to repeat that now because time is short, if one is concerned about that, and thinks that the decline in U.S. listings is a problem, what would you suggest to remedy it? You've already foresworn criticizing Sarbanes-Oxley in your statement. What would you suggest that the United States do?

MR. DeLaMATER: Well, I'm grateful to you for reading that paragraph because I--

COMMISSIONER REINSCH: It's a wonderful paragraph. I commend it to my colleagues.

MR. DeLaMATER: Well, thank you. I'm grateful for your attention to it because I did regard it as an important point, and I shortened it only to try to stay within my allotted seven minutes, but I think that we do need to be cognizant of many of those factors that I mentioned, and I think in terms of concrete steps that can be taken,

I would suggest that more thought be given to whether the current regime that we have, including Sarbanes-Oxley, fully accounts for the unique needs of foreign issuers, and that we remember that the historical conduct of U.S. securities regulation has been to make appropriate accommodations for foreign issuers in these markets.

I didn't set out to criticize Sarbanes-Oxley, but I think some constructive criticism and review of any regulation on a continuing basis is useful because regulations do become outmoded as time goes by or may because of the extreme circumstances under which they need to be adopted. There may not be time to fully consider all the different ramifications, and I think one might say that that was something that happened during the time of Sarbanes-Oxley.

It was a unique set of circumstances, action needed to be taken promptly, but I think in hindsight, there may be changes that can be made, and I should say many of them, the SEC and its staff have been making. They have been very open to

suggestions about ways in which both U.S. domestic issuers and foreign issuers have problems with the current system and changes are being made.

I noticed that just today there was an announcement from the panel that's looking at the impact on small businesses of Sarbanes-Oxley and a suggestion from that panel that the internal controls requirement be delayed to allow small businesses more time to comply. So that these things are happening, but I would encourage those to continue with the particular needs of foreign issuers being accounted for.

COMMISSIONER REINSCH: Thank you.

VICE CHAIRMAN ROBINSON: Thank you.

Commissioner Mulloy.

COMMISSIONER MULLOY: I second Commissioner Reinsch's thank you for being here and sharing your expertise. I think I'm trying to understand--I'm not an expert in any of this, so I'm just trying to understand how it works. You both have talked about the CNOOC transaction in your testimony or in comments, but that's not the thrust of this hearing.

CNOOC was a Chinese company coming here with government subsidized financing to buy an American company. Now, Mr. DeLaMater, you mentioned that they did have a private board or members of their board were private, and indicated that was what they would try and do, put some private sector people. My understanding is that the private sector members of that board were not in favor of that acquisition and, in fact, one of them, the former Ambassador of Switzerland to China, resigned over it. I mean I think that's my understanding.

And that the largest American investor in CNOOC sold its stock because they said this clearly was not a commercial transaction. So just leaving that aside--that isn't the purpose of today's hearing--but I did want to get that on the record because I don't want any misapprehension of what that was about, at least from my perspective and from other people's perspective including the private sector investors and members of the board of that company.

But I think there are two things we're talking about today: people coming here to raise money and it's too bad that Mr. Chao couldn't have made this panel because he makes a differentiation between non-technology companies, which I think are more government-owned corporations from China, not being as willing now to come to this market and it was discussed that they're going to Hong Kong. And I think they're more government-owned corporations which are going to Hong Kong to raise their additional money, and that may be a good thing from Sarbanes-Oxley, that since they are more of a black box, that maybe that's achieving the purpose of Sarbanes-Oxley so people here don't invest in companies that people don't really understand.

But then Mr. Chao tells us there are many Chinese companies coming to the market here and these are the more technology private sector generated companies in China, which are started by, many of them, American venture capitalists find opportunities in China in technology and fund that with American funding to get started, and then come

here and raise additional money in U.S. capital markets to help that private sector, private-owned firm raise additional money, and they're willing to undergo all of the scrutiny of Sarbanes-Oxley.

That's what I got from the testimony today, and I'm just trying to--is that about where you guys are? Mr. Chao had some very good testimony, and I just wanted to see if that's about what you guys think is going on?

MR. DeLaMATER: I agree with that. I think one can divide into those two different sectors, yes.

MR. GECZI: Absolutely, and I think it's important at all times in this discussion to talk about both the public capital and the private capital because we're talking about large market of funds going both directions; some of it is private and some of it is public. And I totally agree with that.

COMMISSIONER MULLOY: I could conclude then that maybe Sarbanes-Oxley is operating correctly in that those who can undergo the scrutiny that's

required under U.S. securities laws can raise money in this market and those that can't, and which we're not sure that the sunshine in signing in, the disinfectant you talked about earlier from Justice Douglas, is really working as well, and so those guys are going to Hong Kong to raise their money or London or somewhere else?

MR. DeLaMATER: Well, as I said earlier, I wouldn't necessarily agree with the proposition that these companies stay out of the U.S. because they're fearful of disclosure. I don't think that is really what drives them to stay away.

Disclosure requirements in other markets around the world are increasing, and there is a movement, very strong movement, toward convergence around the world of accounting standards. You're all aware, I'm sure, of the project to converge U.S GAAP and International Financial Reporting Standards. Disclosure standards are converging through the OECD process.

COMMISSIONER MULLOY: Right.

MR. DeLaMATER: Corporate governance has become a debate in virtually every country and stock exchanges throughout the world conduct seminars on how their listed companies can improve corporate governance. I spoke on such a panel in Singapore, and so there is this movement toward convergence, and so I don't think it's necessarily a fear of disclosure.

In fact, I think I'd say it's a reluctance to have to fit one particular regulatory scheme in all of its many details when one's home market has a different scheme that doesn't fit so comfortably and it, as I said in the comparison between Hong Kong's profit requirement and Nasdaq's willingness to list companies without a history of profitability. One cannot necessarily say that one is bad and one is bad. They are different and they're adopted for different reasons.

COMMISSIONER MULLOY: No, but the non-government owned companies don't seem to have the reticence to come here and raise their money. That's what I get from reading Mr. Chao's testimony,

and that's an important distinction that makes sense in my own head.

MR. DeLaMATER: As I said, in some instances they need to because they could not list in Hong Kong.

COMMISSIONER MULLOY: Because of the fact they didn't show a profit.

MR. DeLaMATER: That's right. The standards are too high in Hong Kong.

COMMISSIONER MULLOY: I heard that. Let me ask you one other issue and this isn't directly related to this hearing. One of the concerns that the Congress had about CNOOC and was expressed was that this government-owned Chinese company was coming to America to buy a company, but that government-owned Chinese company couldn't be purchased in turn.

Now, these Chinese technology companies that are coming to America to raise funds, ownership and control of those companies can pass from the group that controls it now to some other group. Are these groups that are raising money in the Hong Kong

market, these so-called "non-technology" SOEs, are they--they can't be purchased by--I mean control can't be purchased by Americans or non-Chinese government owned people?

MR. DeLaMATER: Most of those companies, that's true in the sense that the government has a majority ownership stake.

COMMISSIONER MULLOY: Yeah.

MR. DeLaMATER: And so absent a decision by the government to sell control, then a purchase wouldn't be possible, but there are at the level of some smaller companies some transactions that are now being done where companies that have in the past been controlled by governmental bodies are being sold to private investors.

One example just from the last year is Harbin Brewery which had been controlled in part by the Harbin municipal government and that was recently sold to an international beer manufacturer and distributor, and so some of these companies are-

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COMMISSIONER MULLOY: Is that a trend we want to encourage in China?

MR. DeLaMATER: Well, I would think so.

COMMISSIONER MULLOY: Do you both of you agree with that?

MR. GECZI: Absolutely.

COMMISSIONER MULLOY: Do you think it would help us to encourage that trend by saying we want a reciprocal investment policy to say if your company wants to come here, this company owned by the Chinese company wants to come here and buy somebody, we're not too much in favor of that unless somehow it can be in turn purchased by private sector people in this country? Would that--there's a guy named Mr. McGregor who wrote a column in the Outlook Section of the Washington Post. He said that was an important concept that we might want to get from the CNOOC transaction, that we move toward a reciprocal investment policy.

MR. GECZI: That's taking place now. I mean IMB-Lenovo. I mentioned Yahoo. I mean those kinds of transactions are taking place.

COMMISSIONER MULLOY: Yes.

MR. GECZI: Several years ago when the massive bankruptcy of Global Crossing in this country happened, the Asian subsidiary of Global Crossing, Asia Global Crossing, which was filing by bankruptcy, was bought by a Chinese company to rescue that company. So the transactions are going forth in both directions.

COMMISSIONER MULLOY: Yeah, I know that, but do you think it should be a policy that if a Chinese company can't be purchased, it shouldn't be purchasing things here?

MR. GECZI: Whose policy? Policy by who? Government policy?

COMMISSIONER MULLOY: Yeah, the government?

MR. GECZI: No.

COMMISSIONER MULLOY: You don't think that would help move the process of opening up the Chinese economy?

MR. GECZI: I think capital markets make that happen. I think the markets make it happen.

CHAIRMAN D'AMATO: Thank you, Commissioner Mulloy. We'll go ahead to Vice Chairman Roger Robinson.

VICE CHAIRMAN ROBINSON: Yes. I think that, building off of Commissioner Mulloy's point, I too was struck by the notion that Nasdaq is the recipient of what we might say, if they're not private firms, quasi-private high technology firms, often, often assisted by venture capital entities or partnering with them, that are seemingly very committed to entrepreneurial activities for their own growth profitability and so forth, whereas the non-technology state-owned enterprises are steering clear for the moment, it seems, of the New York Stock Exchange, although I expect that will soon change, in favor of listing primarily in Hong Kong. I mean that's been the last 12 months, I think.

I mean it's worth noting that I think the commissioners that have participated in this debate now for some years do buy into the notion that the discipline of listing in this country that's inherent in the SEC regulatory regime, our

disclosure standards, accounting standards, are, you know, net positive developments.

I mean it is the kind of thing that brings greater integration of China into the world of financial system in a positive way. We'd like to see more of the Nasdaq variety frankly because it's the large SOEs that really are more questionable from a number of points of view, and that would include the state-owned banks.

Again, when you're selling off ten to 15 percent of the equity with no majority shareholder rights, very little corporate governance, what I'd call poor disclosure and transparency standards, where an investor has a very little idea about what the company actually does for a living, and its overseas entanglements, whether they be in Sudan, Iran, et cetera, that's when you get into more shall we say questionable or dubious territory that can be problematic both for investors as well as for U.S. security interests which is a mainstay of our concerns.

And I think it's also encouraging, and I agree with you, that corporate governance has gained a great deal of traction around the world. I've certainly attended many of those international sessions myself and that as Commissioner Wessel had talked about, we're anxious to see an upward harmonization of disclosure, accounting, and other standards.

This is why you hear questions about whether China is somehow shopping for laxer regulatory regimes as a way to--to take an extreme example of the past--the way BCCI, the Bank of Commerce and Credit International--you might remember--literally went to find the loosest regulatory regimes to set up various illicit schemes.

So we're trying to again sort that kind of thing out and try to reassure ourselves that China is not seeking a laxer set of regulatory regimes that could ultimately disadvantage U.S. investors and our security interests.

So I just wanted to make those couple of points. That's more of a statement than it is a question, and I'd like to yield the balance of my time to Commissioner Wessel, who had I think a concluding question, and before he does I'd like to also say something I neglected to say in my opening statement, which is that our co-chairman for today's hearing, Mike Wessel, has pursued this particular subject of China's presence in the U.S. and international capital markets with great vigilance himself since the inception of the Commission, and has contributed mightily to the evolution of the Commission's inquiries that have taken us I think very constructively into the types of inquiries that you've been subject to today.

So we're very grateful to him for that and with that, please, Commissioner Wessel.

HEARING CO-CHAIR WESSEL: Thank you. As you can tell, it's a mutual admiration society up here. One quick comment on Baidu, if I could. If I remember, they've been cited at times in the past for willingness to block pro-democracy and other Web

sites in China so the reach of concerns that U.S. investors and the U.S. government may have is not necessarily absent in this transaction.

Mr. DeLaMater, if I could just one or two technical questions. My understanding of Sarbanes-Oxley is materiality is based on net income; is that right?

MR. DeLaMATER: No, well--

HEARING CO-CHAIR WESSEL: For disclosure?

MR. DeLaMATER: Well, materiality--

HEARING CO-CHAIR WESSEL: There are many different standards. One of the standards for the disclosure is material transaction is based on net income.

MR. DeLaMATER: That is exactly. That is one factor that can affect whether something is material.

HEARING CO-CHAIR WESSEL: While we were sitting here, I Googled and found out that their net income for the second quarter of this year was 2.4 billion. The purchase of the Chinese bank was \$3 billion, 70 percent roughly of their net income.

That I assume under any legal standard would be viewed as a material transaction.

MR. DeLaMATER: I'm sure they will discuss it.

HEARING CO-CHAIR WESSEL: I'm sure they will discuss it. Let me, though, turn quickly to the Executive Order which the president just announced on June 29, that Chairman Robinson talked about, relating to WMD proliferation. If the bank which Bank of America purchased provides funds to a proliferator, could Bank of America's participation in that transaction, 9.1 percent of the bank is now owned by them, could that be viewed as coming under the ambit of this Executive Order?

Would you as counsel to a firm, hypothetical transaction here, 9.1 percent, they are materially participating in funding a proliferator, would that be something that would be a disclosable fact on their proxy or other statements here, not 144A, but other statements here?

MR. DeLaMATER: Well, as to that fact pattern, I couldn't really say. But certainly I

would agree with you that in general any element of a company's operations that gives rise to material regulatory risk, legal risk, that would imperil their ability to conduct operations or that would have an impact to a material extent on net income or revenues, is something that would need to be disclosed and would need to be disclosed in sufficient detail that it could be evaluated by investors.

HEARING CO-CHAIR WESSEL: Okay. Thank you.

VICE CHAIRMAN ROBINSON: I think that would conclude this panel. We're very grateful to both of you gentlemen for your participation. It has greatly enriched our understanding of this highly nuanced business that we're undertaking today.

We'd like to take a five minute break and then we'd like to convene with our second panel. Many thanks.

[Whereupon, a short break was taken.]

HEARING CO-CHAIR WESSEL: Thank you. We're ready to convene our second panel. Introductions were already done earlier so I will briefly do them.

This second panel is on the upcoming Chinese bank listings and the banking sector.

Dr. Pieter Bottelier, Adjunct Professor, Johns Hopkins University, SAIS. We're pleased to welcome you back here. The professor will discuss the state of the Chinese banking sector as well as China's current strategy for banking reform. Last year, the professor laid out his baseline assessments and we look forward to his further review and future projections of the Chinese banking industry.

Marshall Meyer is the Richard A. Sapp Professor of Management and Sociology at the Wharton School of Business. Dr. Meyer has just returned from Beijing and will discuss the status of China's attempts to sell equity shares in its banks and the implications for both banks and investors.

As Chairman Robinson noted earlier, your statements will be entered into the record. We hope you can roughly speak within about seven minutes for your oral comments so that the commissioners can have adequate time to ask their questions.

Professor. Doctor--excuse me--please.

DR. BOTTELIER: Thank you, Commissioner Wessel and thank you, Chairman D'Amato, for inviting me to appear before this Commission. The written statement I prepared for the record is too long to read in seven minutes, so I will limit myself to just a few highlights of that statement.

The Chinese banking system is entering a critical period. The reform process which started slowly in the early '90s, '93-94, and accelerated after the Asian financial crisis, I think is now in high gear. Much of that has to do with the pressure resulting from China's commitment to open fully the banking system to international participation and competition under its WTO accession terms.

I believe that the WTO terms have forcefully pushed the reform process of the banking sector in particular, but the financial system more generally, in the right direction. Much has happened in recent years in terms of the organization and governance standards for the

banking sector, and I believe that most of the changes are for the better.

Chinese state banks are still state banks, but they are increasingly beginning to behave like banks and less and less as fiscal agents of the state. It sounds paradoxical but the top managers of many of these large state banks are, although Party members, predominantly technocrats and are making major efforts to impress international peers rather than political supervisors domestically.

The state-owned commercial banks, the four large ones, and the banking system as a whole, though still weak by international standards, I think, are in much better shape today than they were a few years ago. The Central Bank and the main regulatory agency for the banks, the CBRC, are improving their performance, are becoming more effective. The Ministry of Finance, which used to be the owners of these banks, has stopped using the state-owned commercial banks as cash cows for revenue purposes. They used to limit provisioning. Those limits have been lifted, and very soon a new

requirement for minimum provisioning will kick in linked to the five category loan risk classification system that the Chinese banks have adopted in 2001. So much discretion on provisioning will actually be reduced.

The composition of the bank portfolios is rapidly changing. There is a remarkable shift towards consumer lending in recent years, and much of that is related to the fact that China's urban housing stock has essentially been privatized between '97 and 2003.

This is one of the largest privatizations in history. It has gone largely unnoticed internationally, but that is driving many of the changes in the financial system as well. Mortgage lending, consumer lending is now accounting for about 16 percent of total bank loan portfolios. It was almost zero in the late '90s and this percentage is rapidly increasing.

We believe that the quality of the portfolios partly as a result of the change in the composition is also improving and we see reflections

in that in rapidly declining NPL ratios and improving capital adequacy ratios.

Three of the large state-owned commercial banks now have NPL ratios that are sort of within reach for preparing international IPOs, and a capital adequacy ratio that meets the minimum international Basel standards.

All banks are rapidly informing themselves internally and are developing as quickly as they can new sources of income other than just margins on lending, particularly financial services, and they do that in part because the competition from for the rapidly growing services market from international banks is just around the corner, when the WTO opening kicks in at the end of next year.

Some improvement or much improvement is also due to the fact that three of the four large state-owned commercial banks have now been incorporated and are legally limited liability shareholding companies. Ownership of those banks has shifted from the Ministry of Finance to the Central Bank, which owns these banks through a

holding company called Central Huijin Investment Company, and that is the company from which international prospective buyers of sharers will buy shares because that is currently the sole owner of these banks.

The NPL clean-up process is still going on. The amount of NPLs on the books of the banks and of the asset management companies that were created in '98 in order to help in the recycling process is still very large, although much lower as a proportion of the total portfolio and of GDP as it was five years ago.

The latest statistics indicate that the aggregate NPL ratio of the four large banks is now down to ten percent and declining very rapidly. But a total amount of NPLs in the total Chinese banking system including the asset management companies is still very large, and ultimately that will have to be cleaned up. That process will take many more years. I believe that if the current stock of NPLs could be frozen, that the resolution of that problem might cost the Chinese state something of the order

of \$300 billion, which is believed to be well within their capacity even without any foreign equity participation.

Most new problems in the banking system that have accumulated in recent years as a result of a big and I think unprecedented lending binge are believe to have accumulated in the smaller banks, not in the large state-owned banks. Many of the city commercial banks, locally owned banks, are facing more serious problems, I believe, than the large banks.

Finally, in respect to one of the specific questions you raised, subsidies through the banking systems to favorite companies, that is extremely hard to measure. We don't really know to which extent that is still occurring. My impression from discussion with Bank managers in China and from general observations is that that is less and less of a problem. To the extent de facto subsidies to favored companies are still occurring, being issued, it's probably more in the form of unintended NPL accumulation than in the form of subsidized loans.

Internal reforms, in conclusion, are in high gear. All three banks that are in line for international listing--the Bank of China, the Construction Bank, and the Industrial and Commercial Bank--are undergoing significant internal reforms. To give you one illustration, Bank of China which is the third largest in balance sheet total and has the lowest number of staff, only about 200,000, has required all managers to resign their positions and has given these managers an opportunity to apply for new positions within the revised and streamlined structure.

If they don't get a new job after three applications, they are out. So very drastic internal reforms, which are consistent I think with the objective to improve governance standards, are ongoing.

I would like to leave my remarks at this, Mr. Chairman.

HEARING CO-CHAIR WESSEL: Thank you. We look forward to reading your full statement in the record. Dr. Meyer, please.

DR. MEYER: Chairman D'Amato, commissioners, I really appreciate the opportunity to appear before you this morning. China's banking system and its banking problems are of immense proportion. As you know, China has four large commercial banks, about 14 national commercial banks like Everbright, Huaxia, Minsheng, et cetera, 113 city commercial banks, and about 3,500 rural credit cooperatives. Even in Beijing, there's a rural credit cooperative, I noticed.

As mentioned, these are huge organizations. Bank of China has about 203,000 employees, about 12,000 branches today--the number is coming down--and 1.5 billion active accounts. Until 2003, the banks were extensions of government. They did not have independent legal status which state-owned enterprises have enjoyed since 1988.

Bank personnel were civil servants and not accountable for performance. Their loyalty, not surprisingly, was as much to government officials as it was to the Bank's headquarters in Beijing.

Since 1994, many steps have been taken to place the banks on a sound commercial basis. One of the first steps was the creation of the three policy banks--the China Development Bank, the Agricultural Development Bank, and EX-IM Bank--in an effort to remove the policy function from the large commercial banks.

Recently, there have been efforts to centralize control of the large commercial banks. Provincial branch managers, at least in principle, are now appointed by an accountable to headquarters rather than local politicians. Local branch offices have become profit-seeking rather than asset seeking. And nonperforming offices in the poorer counties have been closed or shifted to the policy banks.

Importantly, risk management has been consolidated. Today in the Bank of China only 35 provincial level branches as well as the headquarters, of course, can approve loans or credit facilities. The large commercial banks were also recapitalized in 2003, as you know.

Huijin, a holding company created by PBOC, borrowed from Chinese reserves and injected, I believe, \$22.5 billion each into Bank of China and China Construction Bank.

Nonperforming loans were shifted into asset management companies. There's one for each of the large four commercial banks. And the large commercial banks at the same time were separated from the government, reorganized with shareholding companies, and of course given boards of directors. As mentioned, initially there's a single shareholder, Huijin. Ultimately shareholding will be diversified as shares are listed and foreign investors are attracted.

Now, despite these reforms, which have been substantial, many of the people I talk to report that the NPLs remain a problem. How much of a problem is unclear because from time to time loans that are about to be classified as nonperforming are covered by new loans.

The root cause of the persistent NPL problem is also unclear. The simplest and the most

common explanation is that banks retain their policy function. Loans are by command despite improvement in and centralization of risk management. However, research on the NPLs by the Development Research Center of the State Council suggests that this is not entirely the case.

The DRC's research finds that about 30 percent of NPLs arise from government intervention in banking decisions. This is the policy function. And additionally, about 30 percent of NPLs are due to corruption, 15 percent due to bankruptcies, mainly of state-owned enterprises, and about 15 percent of NPLs are due simply to poor banking judgment.

I've left out ten percent there because the total only added up to 90 percent. Forgive me. There are other and perhaps more fundamental problems as well. The business model of the Chinese banks remains rudimentary: take deposits, make loans, live on the spread.

There are few, if any, fee-based financial products and services, at least today. The

performance of the Chinese banks thus is closely tied to the performance of the Chinese economy. The exposure to macroeconomic risk is exacerbated by two other factors:

First, since Chinese capital markets are poorly developed, most household savings go into the bank accounts, and for the same reason the firms, to the extent they are now allowed to borrow, rely on bank loans rather than equity financing.

Moreover, as the banks constrict credit, the SOEs and local governments tend to sell off real estate to raise cash and this balloons mortgage lending and contributes to the property bubble in China.

The solution that is proffered to these problems is corporate governance, reorganize the banks as shareholding companies, recruit independent directors, seek foreign investors and place board representatives of these investors on risk management committees, recruit seasoned managers and centralize control while introducing innovative and profitable financial products.

The mantra of corporate governance, in other words, envisions top down reform of the banks. Whether top down reform is possible in structures as large and politically imbedded as the big four commercial banks is uncertain. Reforming legacy firms in the U.S. or anywhere is very difficult.

Reforming the Chinese banks may prove even more difficult because China, though politically centralized, has been economically decentralized since the beginning of the reform era. Chinese firms are overwhelmingly local and small by global standards. Large centralized firms, save for state-quasi-monopolies in the utility, petrochemical, telecom sectors are quite rare.

Perhaps of greater concern, a gap between the rhetoric and the reality of corporate governance opened last fall. In November of 2004, the executives of the top four Chinese telecoms--China Telecom, China Mobile, China Unicom and China Netcom--were reshuffled by the government. The reshuffling occurred without consultation with the telecoms' boards of directors.

To the best of my knowledge, no independent directors of the telecoms have resigned and none has spoken out publicly.

Despite these issues, the lure for foreign investors is substantial. The size and more importantly the growth potential of the Chinese market is unmatched anywhere else in the world. Where else can you find 1.3 billion potential customers and eight to ten percent annual growth?

There is also, and very importantly, a substantial advantage afforded foreign banks investing in the big four commercial banks and in the national commercial banks: instant access to markets throughout China.

Foreign banks investing in the smaller city banks gain access only to local markets. Foreign banks seeking to open de novo branches in China must negotiate tedious licensing procedures city by city or province by province. Still WTO poses huge risks for Chinese banks with or without foreign investors.

Their liquidity could be threatened by relaxation of currency controls and a rapid outflow

of deposits from China. Their best and potentially most profitable customers, the customers for fee-based services, could be lost to foreign competitors.

There is also an important mitigating factor: China has no choice but to reform its banks. The alternative is nearly unimaginable. The reform of state-owned enterprises has been more rapid and more successful than most people predicted.

It is possible that pragmatism will overcome inertia and that the banks will repeat the performance of the SOEs. As one senior banker--I should say very senior banker--put it: "This is a revolution. If everything is normal, we can overcome the problems. The way is difficult, but the light is ahead."

HEARING CO-CHAIR WESSEL: Thank you.  
Commissioner Mulloy for the first questions.

COMMISSIONER MULLOY: I want to thank you both for your testimony. Dr. Meyer, you've actually presented this in a way that I can really understand

what you're talking about. I want to commend you for that.

I want to raise an issue with you and help me think it through. You talk about the foreign investors wanting to be in China because they get 1.3 billion potential customers and they have eight to ten percent annual growth. Much of that annual growth depends upon exporting.

It seems to me they have more and more export-led growth going on in China. I don't know whether--

DR. MEYER: That's correct.

COMMISSIONER MULLOY: That's correct.  
Yeah.

DR. MEYER: Last year I think it was about 600 billion.

COMMISSIONER MULLOY: Okay.

DR. MEYER: About 60 percent from foreign-invested companies.

COMMISSIONER MULLOY: Now, part of managing an export-led growth economy is the exchange rate issue which we've been talking about with them. I

mean obviously if the exchange rate--what some people think--is 40 percent undervalued, will reach what some people think it should be, that would have an impact on their export-led growth because there would be less investment flowing in and probably more imports and fewer exports. So I think there is some connection between that and the annual growth rate of ten percent.

Now one of the reasons that people say we can't push them too hard on moving their currency is because they have so many problems in their banking system. They can't float the currency, and you allude to that in your testimony saying this WTO thing would threaten the liquidity because of relaxation of currency controls.

Help me understand. What is the WTO going to do that will interfere with their ability to keep their currency controls? How does that work?

DR. MEYER: You'll have to forgive me. I'm not an expert on the provisions of WTO, but I believe that there's a commitment ultimately to make the RMB, the capital accounts RMB convertible.

Maybe someone else here knows whether that is the case. But to the extent that convertibility occurs, the deposits are going to flow out of the banks. Why is that? Well, there is ample evidence. First of all, look at the return that the Chinese households are getting on their bank deposits? It's very, very small. I don't know the number, what it is today, but it's very, very small.

Second, if you look in general, the return on capital in China is much, much lower than outside of China. The numbers I don't have at my fingertips, but they're easily accessible. So there are all kinds of pressures for currency to go out of the country. Now, revaluing that currency upward also exacerbates that pressure because it buys more as it goes upward.

There's another element to revaluation. I don't want to go down this track and take a great deal of time on it--

COMMISSIONER MULLOY: Yeah.

DR. MEYER: --which is also I think very significant, and that is Chinese agriculture.

Chinese farm prices are actually well above Western farm prices, and the government subsidies to the consumers there are fairly substantial.

Right now, 60 percent of the Chinese population roughly is agriculture, which means 40 percent of the people are actually buying food; the rest are eating what they grow. And ten percent of that 40 percent is already imported. And that takes quite a whack out of the farmer's income.

I've heard from folks in the Chinese embassy and lots of other folks, there's grave concern that as the currency goes up, more and more food is imported into the country, and it socks the local farmers--

COMMISSIONER MULLOY: Yeah.

DR. MEYER: --who are already not in great shape right in the pocket.

COMMISSIONER MULLOY: Yeah. Let me just finish up by asking Dr. Bottelier, do you have a clear vision on what this WTO commitment, which I think has to be phased in by the end of next year, to let foreign banks into their market and then take

deposits, what that would mean to their ability to manage their currency?

DR. BOTTELIER: There are two things, Mr. Mulloy. China is committed to open its banking sector completely by the end of a five-year adjustment period, which is the 11th of December next year. After that, foreign banks should be able to enter the Chinese market under national treatment conditions, that there should be no difference between the way national and international banks are treated.

That's an unusual degree of opening for a developing country. It is completely different from the currency issue you raised; there is no provision at all in the WTO charter or in China's accession conditions on capital account opening or currency management, none whatsoever.

COMMISSIONER MULLOY: But if the banks can get in there and take deposits, that will make it much more difficult to manage their currency, won't it, because they can't keep the capital controls on the way they do now?

DR. BOTTELIER: No, the capital controls--

COMMISSIONER MULLOY: Is that correct or not?

DR. BOTTELIER: Excuse me, commissioner. The capital controls are unaffected by the opening to foreign banks. Foreign banks are indeed, should be able to attract deposits both from families and corporations without any restrictions from December next year onward. That has no effect whatsoever on China's management of the currency or on capital controls.

COMMISSIONER MULLOY: Because the foreign banks won't be able to take the capital out of the country?

DR. BOTTELIER: That's correct. They're subject to the exact same capital controls as national banks, yeah.

COMMISSIONER MULLOY: Thank you.

HEARING CO-CHAIR WESSEL: Thank you, Commissioner Mulloy. Has the framework for the transition been set? Have they begun to identify the laws and the legal structure for the full

national treatment that will occur next year? Dr. Bottelier?

DR. BOTTELIER: I cannot answer that in the detail you might expect. The Chinese legal regulatory framework is being adjusted to the WTO requirements. Literally thousands of laws and regulations have been adjusted, newly drafted, in order to make the system consistent with the WTO framework. The particular regulations for the banking system, how far long they are, I cannot answer your question.

HEARING CO-CHAIR WESSEL: As you gain information on that, if you could share that with us, that would be very helpful

DR. BOTTELIER: I will be happy to.

HEARING CO-CHAIR WESSEL: In your testimony, you talk about the potential, assuming I'm reading this correctly, that there may be a new wave of NPLs in the coming years. Could you elaborate on that, and Dr. Meyer, if you could respond on that question as well?

DR. BOTTELIER: I put it in my testimony because the NPL picture, as Dr. Meyer, I think, correctly emphasized, is a very complex one. It is not easy to read off the shelf what exactly is happening. The overall indicators suggest NPL ratios have come down very sharply for the entire banking system and particularly for the big four.

Having said that, I thought it was important to draw your attention to the fact that in roughly from the third or fourth quarter of 2002 through the first half of 2004, there has been another unusual expansion of bank lending in China.

Part of that was, I think, to avoid sharp economic slowdown following the SARS epidemic, but it has led to an unusual increase in the investment ratio, and since most of the incremental lending during this period did not come from the big four state-owned commercial banks but from the dozens and dozens of smaller banks, most of which are locally owned and not necessarily adhering to same standards, and since most of the deposits have continued to flow to the large four, there is a

serious possibility that much of the incremental lending by these smaller banks has been financed from short-term borrowing on the inter-bank market.

HEARING CO-CHAIR WESSEL: And those banks are not the ones that will be participating in the international markets for--

DR. BOTTELIER: Well, some of them are. I mean--

HEARING CO-CHAIR WESSEL: The smaller ones?

DR. BOTTELIER: Many of the smaller city commercial banks which are incidentally not all that small are already internationalized. They are incorporated and some of them already have foreign minority participation.

HEARING CO-CHAIR WESSEL: Okay. Thank you.

DR. BOTTELIER: Some are listed, in fact. But the good ones amongst them will not have misbehaved, but the majority are not yet listed, and I would not be surprised if at some point, if the economy turns down more sharply than currently expected, or if the property markets in Shanghai and some other city collapses, that we will find that

some of these smaller banks find themselves in acutely liquidity problems because they borrowed short and lent long.

So the maturity mismatch on the balance sheets may have become quite serious. That could lead to sort of isolated banking difficulties and instability here and there, and my suggestion was that there may be another wave of NPL coming as a result of that. It's uncertain. If the economy slows down on a more orderly pattern, there is a good chance that that will not happen, and that the NPL portfolio will merely stabilize or shrink more slowly than has been the case.

HEARING CO-CHAIR WESSEL: Dr. Meyer, do you agree with that assessment?

DR. MEYER: I'd like to illustrate Dr. Bottelier's point very briefly. To illustrate the cyclical nature of the NPLs, as Dr. Bottelier pointed out, the SARS epidemic opened a wave of lending. There was a lot of lending to households for purchases of automobiles. Folks were a little

wealthier; they didn't want to ride the bus during SARS, et cetera.

It turns out in a relatively short period of time about a third of the purchasers and their vehicles simply vanished. And the central government then clamped down severely on auto loans leading to the current tailspin in the auto industry.

One of the big issues in China is the poorly developed state of the consumer credit system. There's some experiments going on in Shanghai, some experiments going on in Beijing, but basically China still has nothing approaching the credit reporting systems that we have in the United States and, hence, household loans, except for real estate loans because real estate does not walk away, are still quite risky.

HEARING CO-CHAIR WESSEL: Okay. Thank you. Commissioner Wortzel.

COMMISSIONER WORTZEL: Thank you very much. I would like to pursue the comments that you made about Huijin, Dr. Meyer, if I could. This holding

company borrowed from foreign reserves, as I understand it, and then used that to recapitalize People's Bank of China, or Bank of China and China Construction Bank. How is that transaction or loan carried on the balance sheets of the foreign reserves?

And then I'll follow it up with a second question and leave you--both of you?

DR. MEYER: I think I'm going to have to defer to Dr. Bottelier on that. I don't know the answer to that.

COMMISSIONER WORTZEL: Okay. And then I ran into a situation--I think it was about 2000--Shenyang Iron and Steel had thousands of retired workers, 50, 60,000 retired workers, who were directed, ordered to take their savings out of the bank and buy bonds in Shenyang Iron and Steel which wasn't producing, and those bonds were used to capitalize the company because the workers hadn't been paid, the retirees hadn't been paid, and then they were paid.

And they put the money that they were paid in part back into the bank and then the bank loaned the money to the company so it could continue to function. Now, it strikes me that that's kind of a shell game. What happens if a bunch of depositors want to life up a shell, in other words, if they want to take their money out of the bank and put it in a foreign bank when a foreign bank can receive those deposits? What's that going to do up in a place like Shenyang to stability, to the viability of the industry?

DR. MEYER: I think that's the issue of capital controls. Lift those capital controls and I think the scenario you described could occur in many places in China, and hence a high likelihood that the capital controls will be retained for some while in China.

COMMISSIONER WORTZEL: Because they can't afford to open? I mean it would be too unstable to them.

DR. MEYER: Just a street-level observation. Something new in China starting July

1. They're beginning to enforce seriously the regulation that you can't carry more than I believe 20,000 RMB out of the country. I'm not sure of the exact number because I didn't come anywhere near it, but for the first time, you now have to fill out paperwork specifying how much currency and whose currency you're carrying out of the country.

COMMISSIONER WORTZEL: The foreign reserves balance?

DR. BOTTELIER: Well, you raised two very interesting but very different matters, commissioner. If I may address the first one first on the recapitalization of three of the banks, not two, but three, through Central Huijin. That surprised the financial community. It was an unorthodox transactions, and I'm not sure that we know all the details, but let me describe what I know.

The Central Bank created this new holding company, Central Huijin Investment Companies, to which it lent a certain amount of foreign exchange. So on the balance sheet of the Central Bank, forex

reserves were replaced by a claim on Central Huijin, still in foreign exchange.

Then Central Huijin invested that money in the form of equity, pure equity, first in two banks and later in three; a total amount of \$60 billion has been transferred in that way. That in itself is also unorthodox because these are local banks and they have been recapitalized in part with foreign exchange, so that foreign exchange cannot be immediately converted into local currency because that might become inflationary, so there are restrictions.

So you have a chain of accounting transactions which are genuine. Real resources have been transferred and it is a real capitalization, had never been done to my knowledge in the world before, so on the specific question you raised, what happened on the balance sheet of the Central Bank, it surrendered forex reserves in lieu of a claim on Central Huijin. Central Huijin will at some point have to compensate the Central Bank.

On what terms that money has been made available to Central Huijin, we don't know. That has not to my knowledge been made public. It may at some point.

Now, on the question you raised on the Shenyang retirement workers, I'm not familiar with the details, but I believe the implication of your question was what will happen if foreign banks can take deposits locally so the capital account restrictions don't really come in here.

And I believe that is a serious risk and that is a risk that China accepted by entering in the WTO on these terms. The experience internationally is that foreign banks do not quickly gain a large proportion of the total deposit base in a country, and it probably will not happen in China very quickly, but if we take a five to ten year horizon, there is a prospect that indeed a lot of local depositors will feel safer putting their money in Deutsche Bank in Citibank rather than keeping with the local bank in Shenyang. So that is a real risk and I think that is precisely at the heart of

what is going on in China. That is why there is so much pressure on these banks to become banks.

COMMISSIONER WORTZEL: Thank you very much.

HEARING CO-CHAIR WESSEL: Thank you.

Chairman D'Amato.

CHAIRMAN D'AMATO: Thank you very much, Mr. Chairman. This is a very, very interesting discussion. I have a lot of trouble understanding how the Chinese are going to, quote, "open" their banking system up by the end of 2006 and retain a Leninist structure of power in China.

To me an open banking systems mean that, you know, I come from the Senate where the power of the purse is the most important power of the Congress. Clearly, the power of the purse in shifting the structure of power in the banking system away from centralized political control would end this political structure in my opinion.

I don't know how it could happen otherwise. I don't know how anybody can answer that, but if there's going to be truly an open banking system,

there is going to be change in this political structure it seems to me that follows.

Power follows the money. And by the way, I also want to commend you for making a presentation that Commissioner Mulloy understands.

[Laughter.]

CHAIRMAN D'AMATO: Only kidding. I have one quick question. And that is we have all these banks, all are rated at the bottom by the rating houses, that want to come in with IPOs. I want to understand what IPOs have to do with the bank opening process. To me, these IPOs, and what I understand are not necessarily billions of dollars that are absolutely needed by these banks, but are an opportunity for these banks to grab additional money off the international capital market just to get it.

Maybe I'm wrong in that understanding, but that's what my understanding is. What do the IPOs of these banks have to do with bank opening? Anything at all? Can you tell me, either one of you?

DR. BOTTELIER: May I address your first question first, on the possible links between financial system reform, banking reform and political reform, I totally agree with you. It is hard to imagine that you cede real power to banks without also ceding political power. And that is a process, in fact, that is going on. One of the paradoxes of the whole Chinese reform process is that this is a one-party state which has created markets, and markets have real power, and that process is still going on. And they know it.

How they think that through and how that is understood is quite frankly beyond most of us, but this is the reality of the Chinese reforms and is one of its remarkable ironies and paradoxes. I know quite a number of the senior managers in the banking system and they're all highly trained technocrats, and as I mentioned in my introductory remarks, these people look now to the internationalization of their operations as an opportunity to become internationally peer-reviewed so to speak.

The internal political processes recede into the background, and that leads me to the answer to the second question, the links between IPOs and the opening up of the banking system. I believe that for most of the bank, certainly for Bank of China, the money of the IPOs is much less important than the international respect and credibility that this whole process conveys on them.

Strictly speaking, they don't need the money.

CHAIRMAN D'AMATO: Yeah.

DR. BOTTELIER: They have enough money to recapitalize those banks 100 percent as necessary. But the IPO process is very important (a) because it allows foreign minority board members to become an important factor in the deliberations at the board level, and that's precisely what they want. One of the main motivations of these banks to seek international minority shareholders is to make it easier for them to pursue better governance standards internally and to deal with the residual political processes internally.

This is a very complex process, and I'm not sure I can fully understand it or explain it to you, but this is really what is going on. They seek these IPOs, not in the first place for the money, but to gain the respectability and to improve the chances that they can improve governance standards.

When I discussed these matters with senior manager of Bank of China, for example, they are still, I think, hell bent on going to New York in spite of Sarbanes-Oxley which imposes enormous additional costs on them. They said, on, we don't mind the costs. They immediately hired the seven or ten additional auditors needed in order to meet all the requirements. No time table has been set.

The Construction Bank, I believe, is considering more Singapore and London, and I'm not sure I'm familiar with all these considerations, but the IPO process, to sum up, is very important as a capping stone on the internal reforms in these banks and to separate them as much as possible from the government itself and from the Party.

CHAIRMAN D'AMATO: So an internal revolution is going on here.

DR. BOTTELIER: Absolutely.

CHAIRMAN D'AMATO: We're announcing it today.

DR. BOTTELIER: Absolutely.

CHAIRMAN D'AMATO: Dr. Meyer, do you have any comment on that?

DR. MEYER: I fully agree with what Dr. Bottelier has said. I think the trade is this: the IPO and the foreign investments are intended to bring discipline into the organization. Now whether that can and will happen is a different question. But that's the theory that's on the table.

Let me give you an analogy if I can. All of you, I'm sure, very aware of the Lenovo acquisition of the IBM PC, the ThinkStar business. They chose to move their headquarters to purchase New York in order to not only acquire but impose Western management, but to impose Western management throughout their system. So there's an analogy

here. This is not an IPO situation with Lenovo, but I think the analogy holds.

Now, on the side of the investors, not so much the individual investors, but rather the Western bank investors, the foreign bank investors, and the Chinese banks, again, what they're seeking is access, quick access to Chinese markets. So 11/06, they're set to participate in the Chinese market. So I think that's the trade that's going on here.

I agree they don't need the money with 700 billion in foreign reserves. I don't think there's a terrific need for cash over there at this time.

CHAIRMAN D'AMATO: Well, I think that's very, very interesting. I think that from my observation of China, and generally speaking, is that they are incredibly well organized in terms of their goals and how to reach them, given the size of the country and their goals and how quickly they've accomplished many of their goals.

It will be, I think, a challenge to their organizational ability to retain central political

control and let this process go forward, as you've described it, and I think that will be a huge interesting dynamic to watch. Thank you.

HEARING CO-CHAIR WESSEL: Vice Chairman Robinson.

VICE CHAIRMAN ROBINSON: Yes, thank you, co-chairman. You know I share Chairman D'Amato's wonderment on this. There's a schizophrenia going on here it seems to me. You know when I hear the idea that they're going IPO to bring greater discipline to their system, I buy that. Certainly gaining respect, prestige, greater freedom of action, I buy all that.

Minority shareholder rights and the fact that they're keen to empower minority shareholders, I'm not as sure about that. Whether they really want a voice of independence in the board room, it depends what subject matter. For example, the schizophrenia in my mind gets into this business of when you look at Bank of China, for example, or the Construction Bank, for that matter, you have the commercial side of their activities, and then you

have a very politicized set of activities that involve Chinese energy acquisitions in oil producing, terrorist sponsoring states.

You've got their military modernization program that's implicated. You've got customers of the bank that are known proliferators of weapons of mass destruction. In other words, you've got a lot of sporty, to say the least, dubious activities that are part of this mix.

So I'm not sure--I don't know how elegantly I'm putting this--but I'm not sure that the Chinese leadership has sorted this out. I think that many of the folks working for the banks want them to be peers with their counterparts worldwide, and that there's a lot of momentum in that direction. I just wonder how it's going to square with China's other priorities, geopolitically and militarily, for example, just to name two, that tend to run at cross-purposes with the kind of openness, with the kind of good governance, with the kind of minority shareholder rights that we're talking about.

So that's one. I'd like you comment on that question. I don't know that I've put it terribly well, but I think you get my drift. These are working at cross-purposes at some level.

Second, a question along the following lines. If a state-owned enterprise is going to list on the New York Stock Exchange, and it has one or two subsidiaries that have been sanctioned by the United States for the proliferation of weapons of mass destruction, do you feel that that is a material risk to investors that should be properly disclosed in the prospectus and SEC filings of that IPO? I mean that's just a straightforward question as to whether you think that as a parent company with two subs that have been charged with proliferation offenses, is that the kind of thing that an American or other investor should know going into an IPO?

Can I just have your quick response on that one before I go on? Does that strike you as a sensible proposition?

DR. BOTTELIER: In light of the presidential directive, the recent one, I think that sounds to me like a reasonable proposition.

I would not make this a China-specific requirement. I would make this an international requirement--

VICE CHAIRMAN ROBINSON: No. Clearly.

DR. BOTTELIER: --for anyone who wants to list here--yeah.

VICE CHAIRMAN ROBINSON: And Dr. Meyer, I assume that sounds right to you or?

DR. MEYER: I think that's correct. I also think that, again, given the size and the scope of the four large state-owned banks in China, some of what you describe is inevitable.

VICE CHAIRMAN ROBINSON: Well, and a similar question. If you were to invest in Bank of China and the China Construction Bank, would you find it helpful as an investor to have in front of you a breakdown of the loan portfolios of these institutions? I mean the loans of a bank are its assets, asset quality, you know, whether it's

nonperforming loans--of course, this is important. But also you probably want to look at other things, too. I mean who are their customers?

We have some idea of who their customers are. It goes to the point you just made. Some of them are, shall we say, colorful, is a polite way to put it. Do you think that they should be required to disclose their loan portfolios before coming to market or should U.S. investors be content to invest in a black box in terms of these loan portfolios?

DR. MEYER: The way the question is posed, I think the answer is foregone.

[Laughter.]

DR. MEYER: However, there is a particular issue in China, and that is the firms such as they are are organized as parent-subsidiary system. Because a loan goes to Firm X does not mean that its ultimate beneficiary is Firm X, because Firm X most likely has interests in 200 other firms, and what full disclosure would entail would be to delightful for scholars like Dr. Bottelier and me. We could study this forever. Whether investors could make

sense of it quickly I don't know, but that's one of the aspects of doing business in China: you don't always know who you're doing business with.

VICE CHAIRMAN ROBINSON: And Professor Bottelier?

DR. BOTTELIER: As a potential investor, I would certainly like to know that the accounts of the company that I'm potentially investing in have been properly audited, and I would look at the auditing report. As an individual investor, I'm not sure I'd like really to see the list of borrowers of the company, certainly not the Chinese banks, because there are likely to be hundreds of thousands of accounts, and I have no way or wherewithal to actually scrutinize those for the purposes that you have in mind.

I think in light of the presidential directive, and if there is a serious security concerns here, I believe that that aspect has to be dealt with in a different way. I think here the regulatory authorities, I think, would have to shield the nation's investors from getting into

situations that are inconsistent with national security objectives, but how you do that is beyond my competence.

VICE CHAIRMAN ROBINSON: Thank you. And you, basically I take it, I mean your reaction to my first point of the fact that there may be obviously some cross-purposes in the way China is managing its bank opening is something you'd likewise agree is the case?

DR. BOTTELIER: Well, I think the way you put it, the question about schizophrenia and the lack of protection for minority rights, I think are real questions and there is no question in my mind that this whole process in China is hard to understand and hard to put your arms around.

What I was saying earlier is that it is remarkable in a way that this one-party state is, in fact, creating a market economy which by definition means that it is surrendering power to other forces outside the immediate control of the Party, and that process has gone quite far, and I think will go a lot further.

Whether that ultimately signals an inconsistency between the political system and the economic system is another question. I believe there is. So I believe that the economic reforms that are going on will increasingly put pressure on the economic system, on their political system as well.

I cannot really see a totally reformed market economy with a one-party state quite frankly, but that's a personal observation. This has not happened in the world before, certainly not on this scale. Nobody knows the outcome of this process.

All we can say is that they've come a long way in 25 years and that remarkable and rather paradoxical things have happened in the process.

VICE CHAIRMAN ROBINSON: Thank you. Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Dreyer.

COMMISSIONER TEUFEL DREYER: I have a more micro-level question. I'd like to ask you gentlemen to address the issue of what level of confidence the

average Chinese who puts her or his savings into the bank has in those banks? We have heard that NPLs are still a matter of concern, and also that interest rates are low. There have been predictions that some day there will be a run on the banks that could cause the financial system to collapse.

Is this even remotely conceivable? And if so, under what circumstances might you expect it to happen? We have definitely heard of small scale runs on banks in certain areas. Gentlemen.

DR. BOTTELIER: I believe the banking system is no where near completion in its reforms, but I do also believe that it is better shape today than it was five years ago.

The risk of a serious banking crisis in China today is much lower, I think, than it has been for a long time. And that's partly because the quality of the portfolios of these banks have improved and P/L ratios have declined, capital adequacy ratios have improved, but the quality of management of these banks has also vastly improved. The technical capability, the management information

systems is not comparable to what it was ten years ago.

In addition to that, the Central Bank being always aware of that risk has created a financial stability department as part of the Central Bank. The managers of that are the watchdogs of the system in parallel with the banking supervisory agency, but they are empowered to intervene in the event of local bank runs.

So there is a very low probability that in the event of a local bank run, as has happened from time to time, that that would quickly spread to affect the entire system. I believe that barring major catastrophes, the system is essentially stable and that the Chinese depositors have the confidence in the state banks where they keep about 65 percent of their deposits because they're not seriously concerned that the system will unravel.

COMMISSIONER TEUFEL DREYER: Thank you.  
Dr. Meyer.

DR. MEYER: Well, my information comes from a survey of about nine people whom I've asked this

question to: Do you have confidence in the bank?  
Does your family have confidence in the bank? And  
uniformly the answer is yes.

So at this point, you know, and this is  
mainly in Beijing, at this point my guess is--and  
this is a guess--is that consumer confidence in the  
state banks is pretty high. The likelihood of a  
panic I would guess is also fairly low, if only  
because the kind of information that's needed to  
create a panic could be bottled up pretty darn  
quickly in China.

Increasingly with internet, that risk might  
go up a little bit, but people would not necessarily  
hear of a run on the bank in the next community in  
China as they would immediately hear in other  
countries.

COMMISSIONER TEUFEL DREYER: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner  
Reinsch.

COMMISSIONER REINSCH: Thanks. I just  
have, I think, a short question. I gather from what  
you're both saying is that the process of reform

seems to be underway with some success so far.

Assuming the absence of a macroeconomic crisis, and assuming that the government continues its policies of reform, how long is it going to take the banks to get to the point where they would be competent and healthy in a Western sense, either one of you?

DR. BOTTELIER: Some are already. I think some of the smaller publicly owned bank, like the Bank of Communications in Shanghai, actually is a pretty modern bank already. That's small by Chinese standards, but still it's 50, \$60 billion balance sheet total. I think these local relatively old banks because this is inherited from a preexisting bank are approaching, I would say, acceptable standards of management and governance fairly rapidly.

Of the big four state-owned commercial banks which are owned by central government, now through the Central Huijin, I think Bank of China is probably advancing more rapidly than the others towards acceptable international standards but is not close to it yet.

Second one would be the Construction Bank. The third one the Industrial and Commercial Bank with the Agriculture Bank lagging the field by several years. The most serious problems in terms of governance standards, management information standards, I think are no longer in three of the big four, but in the multitude of relatively small local banks which are not incorporated.

Many of the city commercial banks, the rural banks, that I believe is where there is a large residue of bad things going on.

COMMISSIONER REINSCH: And that's going to take a lot longer presumably?

DR. BOTTELIER: Much longer, yeah. But I think at the top level, I think the progress that has been made in terms of governance standards and internal discipline has actually moved quite fast in the last five years.

COMMISSIONER REINSCH: Dr. Meyer, do you agree with that?

DR. MEYER: For the most part. Two comments. First comment is that big banks, big

organizations anywhere, are very difficult to change. And I was interested in the phrase just spoken by Dr. Bottelier. He said at the top level the reforms in the large banks are deeply imbedded.

I think the question, an important question, is to what extent the reforms undertaken at the top level of the very large Chinese banks have penetrated to the level of provinces almost certainly but beyond the provinces to the counties and the townships because it's at that level, even within the large banks, that the problems can occur.

As to the smaller banks, the only comment would be this--a lot of variance. For example, I've watched very casually Pudong Development Bank because of Citibank's investment in it and that seems to be moving along rather nicely.

On the other hand, there is some local banks which seem to be very recalcitrant to change and the time horizon there who knows, so I would say just to summarize, top to bottom in the large banks will take time. Need more data about what's happening at the bottom. A lot of variance across

local banks because Chinese localities, the local economies are dramatically different from one another.

COMMISSIONER REINSCH: Is there anything that the United States government can or should do to facilitate this process?

DR. MEYER: Perhaps. I've often thought that investment in a bank is one act but reforming a bank is something else. The current mantra of corporate governance suggests that the two go hand in hand. If you take a position in a bank, you're in a position to influence that bank, and bring it along the reform process.

But again, to go back to my prepared remarks, that assumes that top down can work. I question whether that's a safe assumption in China because SOE reform was definitely not top down. It was bottom up. And it was very experimental. So the question is what other steps can we take to encourage bottom up reform whether it's in the smaller local banks or at the lower levels of the large Chinese banks? I'm not sure what those steps

are, but I think it could be worthwhile investing some thought as to what those steps and what agencies might promote those steps, what those steps might be and what agencies might promote those steps?

COMMISSIONER REINSCH: Thank you. Dr. Bottelier, do you have any?

DR. BOTTELIER: I'm not sure that there is much the United States government, the federal government, can do to help or facilitate this process, but I believe it is very important that individual agencies such as Justice, Treasury Department, maintain intensive links with their counterpart agencies including the Central Bank, mind you, to accompany that whole process of technical and system transformation in China.

One important little detail that is in my written statement which I did not mention for lack of time, but is nonetheless important, is that the American Bankers Association is about to sign a contract with the Chinese Central Bank and the banking supervisory agency for a national training

program at all levels in the Chinese banking system combined with a new locally designed certification system.

ABA has had that system in the United States for a very long time and has one of the largest banking training programs in the world domestically in this country. That entire system will now be made available, the experience, to train Chinese bankers to become better bankers and to insert in the system professional certification standards which they currently do not have.

Right now if a banker applies for a banking job in the United States, he is required to meet certain certification standards. The Chinese have come to the conclusion that that is very useful to improve their own standards and they have requested the ABA to help them to develop such a certification system.

Now, that's outside the federal government, but this is the level of, I think, cooperation which is very important.

COMMISSIONER REINSCH: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Mulloy for a quick closing question.

COMMISSIONER MULLOY: Thank you. The question that you mentioned the consumer lending on automobiles. I've read, I remember reading something that the effect of this, the government put easier consumer credit for purchasing automobiles, and you mentioned that this might have been--and the people didn't want to ride public transportation. I don't know whether that was part of it. But as a consequence, more investment flowed from the foreigners into helping China build its automobile industry because there was more demand for automobiles during that period of time.

And now that demand for automobiles has not been as great in China, so this money that now is there and built this capacity is now looking for export markets for these automobiles. And so somebody here or somebody in some other country is going to lose a job because of the way this system is working.

Do you have any policy prescription to deal with things like this? I mean something is wrong with the system when it can behave that way, and I just want to get, you know, you guys are real experts on this. What do you think about we ought to be doing or what can be done? I turn to both of you.

DR. BOTTELIER: Well, I think Commissioner Mulloy puts his finger on a very real issue and a very serious problem. I think it is in the nature of the unreformed system in China that you get these crazy credit benches you've had as I referred to earlier. That has led to a lot of excess capacity in the manufacturing sector, some of which will now come on international markets, in part because the Chinese have slowed down domestic credit expansion in order to get the overheating under control.

In the case of automobiles, and that's an excellent example, that's precisely what has happened. There is tremendous capacity that has been built in China in the anticipation of very rapid further domestic market growth which is not

materializing right now in part because they've clamped down. They've told the banks no longer consumer credit for cars. Mortgage is fine because that's secured. Car security is very, very difficult.

So they're waiting now for other--the big motor companies like Ford and GM are pushing the Chinese government, again under WTO, to get the right to provide the financing themselves outside the banking system, which they should be allowed under WTO, and that may help to stimulate domestic demand.

But the generic issue you raise, namely, how do we deal with this tendency of Chinese manufacturing to develop excess capacity and then export the surplus, that's a major issue, and I don't belittle that. I think the problem will not go away until the system is truly reformed.

DR. MEYER: The first two people to lose their jobs were Phil Murtaugh, the head of GM China, and I think I have the name straight--I'll look in my file here--I think Bernd Leissner, Dr. Leissner,

who is the head of Volkswagen in China, both lost their jobs this year in a very short period of time. Indeed, it was quite awkward. I happened to attend the Baao Forum, which is, you know, China's equivalent to Davos. Obviously the format and the security are very different.

But there was a session on the automotive industry there, but as you walked in the door, you were informed in no uncertain terms that the discussion would be focused only on the industry and not on specific companies, most of which are in bad shape. I think the real threat to jobs, as mentioned, comes from manufacturing surplus in China, and the manufacturing surplus is partly a function of the fragmentation of the economy in which every provincial governor is seeking economic growth, encourages investment and encourages bank loans to support manufacturing in all industries, and as a result, the domestic markets in China are hypercompetitive and, heck, in many instances not sustainable, and the excess goes abroad quite rapidly. But that's a much larger issue.

COMMISSIONER MULLOY: Thank you. Thank you, both.

HEARING CO-CHAIR WESSEL: The Commission will recess until 2:00 p.m., and look forward to seeing you at that time.

[Whereupon, at 1:00 p.m., the hearing recessed, to reconvene at 2:10 p.m., this same day.]

A F T E R N O O N     S E S S I O N

[2:10 p.m.]

HEARING CO-CHAIR WESSEL: Please be seated so that we can start the panel, please. Good afternoon. Appreciate everyone coming back and having our third panel here this afternoon, "China's Strategy in International Capital Markets and the Implications for the U.S."

We're honored to have three distinguished panelists with us this afternoon. Frank Gaffney is President and Founder of the Center for Security Policy and former Assistant Secretary of Defense for International Security Policy in the Reagan administration. He'll address the security concerns that have emerged from China's growing role in the international capital markets.

Dr. Solomon Tadesse is an Assistant Professor of International Finance at the Moore School of Business. Professor Tadesse has published numerous books and articles on these topics and will provide an overview of Chinese strategies and

objectives in global capital markets and their implications for those markets.

Mr. Donald Straszheim--I hope I've pronounced everyone's name correctly--is chairman and CEO, Straszheim Global Advisors, LLC, and former Chief Economist for Merrill Lynch. Mr. Straszheim will discuss Chinese strategies and objectives in global capital markets and their implications for U.S. investors.

As an expert in the field for over two decades, we hope Mr. Straszheim's conclusions will help the Commission better understand how industry experts perceive China's strategy in the international capital markets.

As is our normal process, we will give each of our witnesses about seven minutes to present their oral comments. Their prepared testimony will be made part of the record, and then we'll open it up for questions from the commissioners. Mr. Gaffney, if you could start.

MR. GAFFNEY: Mr. Chairman, and I guess I should say Mr. Chairman, Mr. Chairman and Mr.

Chairman, thank you very much for including me. I have a lengthy prepared statement which I would appreciate, as you say, having it in the record, and I will try to do it justice in seven minutes.

I wanted to say before getting into the meat of this meeting how much I personally appreciate the members of this Commission and the work that you're doing. I think the fact that we as a nation have a second opinion on China from an independent, all-source informed, and official vehicle is of incalculable importance, particularly at a time when I think the sorts of insights that you all have come up with over the four or so years that you've been in business are not given nearly enough attention elsewhere in our government.

Secondly, I think it's fair to say from your record of hearings and reports that China is systematically pursuing a strategy, one that I think should alarm freedom-loving peoples in this country and around the world. As Chairman D'Amato knows from our joint appearance before the House Armed

Services Committee recently, I believe that strategy's purpose can be summarized as follows:

To displace the United States as the world's preeminent economic power and if necessary to defeat us militarily.

And I believe that the subject of today's hearing is very much part of and a critically important ingredient in the implementation of that strategy.

I can't let the opportunity pass to say a particular word of appreciation for a long-time friend and colleague of mine, your Vice Chairman, Roger Robinson, who frankly has taught me most of what I know about this subject, so I think I'm probably today going to be reduced to trying to amplify, augment, and reinforce findings and recommendations adopted by this Commission under his leadership.

We have, as I mentioned, recently gone through what I think is a very important and hopefully instructive exercise in the ultimate defeat of a state-owned Chinese enterprise known as

the Chinese National Overseas Oil Company's efforts to take over an American energy company, Unocal.

Indeed, it was heartening as I was putting these remarks together yesterday to have Unocal's shareholders reject that idea in favor of Chevron. We should be under no illusions, however, that China as long as it is governed by the Communist Party will continue to both exercise dictatorial control over the country and its resources, not least the immense wealth that is being accumulated as a result of America's record trade deficits with China, and those resources will be put to the various purposes described in that strategy.

These will include among other things efforts to acquire or purchase, to gain by theft, if necessary, strategic energy resources, minerals, materials and technologies. You will see a continuing and I think accelerating and increasingly offensively oriented military build up, including something I think this Commission is familiar with, a concept the Chinese call the "assassin's mace," evidently a program for decisively defeating the

United States military, and I hope if you haven't done so already that the Commission will take an opportunity to receive a briefing by another blue ribbon commission that looked at one way that might be accomplished, namely through an electromagnetic pulse attack against this country delivered by ballistic missiles.

The Chinese will also, I think, continue to seek to dominate strategic chokepoints around the world and other pivotal regions from Africa, Siberia, the Middle East, Central Asia, and Latin America, to of course the United States as well.

I hope that your findings in this area and recommendations will be translated this session of Congress into legislation, and we look forward to working with you at the Center for Security Policy in doing that.

Turning now to the matter at hand, China's deliberate systematic effort to use the U.S. and foreign capital markets to sustain many of its state-owned enterprises and to underwrite their

activities is, as I said, I think, an important part of the strategy I mentioned a moment ago.

I think that they have understood that instead of having the Chinese Treasury support these enterprises, some of which are frankly not in very good shape financially, by bringing them to market in the form of IPOs, they can get American and other investors to capitalize them.

The question before us today is what are the financial and strategic implications of such transactions? And I think that they are, in short, not good for the investors and certainly not good for this country, especially since it appears that in doing such underwriting of these state-owned enterprises, we are likely to be underwriting such things as the manufacture of intercontinental range ballistic missiles, space-based and other weapons designed to blind our satellites, the proliferation of weapons of mass destruction, the suppression, in conjunction with police units and regional and level governments, of human rights, the despoiling of the environment, the crushing of Tibetan freedom and

various business dealings with terrorist sponsoring states.

I don't believe that American investors would want any part of doing such things if they knew that that was the practical effect of their investments, but of course they don't know. And this is one of the really extraordinary things that I would commend this Commission to make an intensive effort to correct.

It is unimaginable that American investors would be making similar investments in companies that are black boxes, but offered by American concerns, and yet that is by and large what seems to be happening, especially with respect to banks, that China now evidently has in mind bringing to our capital markets.

These are--let's be clear--foreign owned, foreign government-owned entities, not private firms, and whether in the hands of investment bankers in the West, these banks and other concerns are dressed up to make them look a little bit more financially attractive, a model perhaps being

adopted from the American experience with the savings and loan fiasco, in which bad debts were simply offloaded onto asset managers and the books somehow miraculously get cleaned up, it's still not in our interests to be subsidizing activities that banks are making loans to and in other cases companies that are doing such activities directly.

There is a very interesting and important precedent with which I think this committee is familiar, certainly Vice Chairman Robinson, in dealing with such entities, namely the effort that the Chinese National Petroleum Corporation made in 1999 and 2000 to come to the market with a major IPO. I think it was intended initially to be something on the order of \$10 billion.

A coalition, an unlikely political coalition of Americans across the political spectrum came together to oppose and to educate the public, and particularly the investors about what was really going on in CNPC. It prompted CNPC's again investor managers to come up with a subterfuge. They called it PetroChina, a subsidiary that ostensibly had

nothing to do with the parent company but, of course, was part and parcel of it, and did not in the end mislead I think investors into believing that CNPC was not active in Sudan.

Indeed, CNPC is today, we're told, in a position to own a 40 percent equity share in the Greater Nile Petroleum Operating Company of Sudan, and reportedly takes 50 percent of its oil production. I mention this only because I think that this is an important precedent. The shareholder activism and the other efforts to educate investors about what this company was about prompted approximately a 70 percent cut in the value of this transaction from about \$10 billion I believe to something on the order of 2.8 billion.

I would suggest to you that this Commission could very usefully help focus attention on similar transactions not only of those that are coming to market or coming into the United States as CNOOC tried to, but also those that are coming into our bond and equities markets, especially those that we have reason to believe are actively involved in one

way or another directly or indirectly in the kind of activities that I mentioned before that are clearly contrary to our interests.

In my testimony, I identify a number a steps that I would recommend this commission take on, building on your legislative mandate, building on your past record and findings. I also have made some suggestions about the importance, as I know Roger Robinson did in today's Financial Times, of getting the newly ensconced chairman of the Securities and Exchange Commission to get that institution actively engaged in increasing the transparency, the accountability, the good governance, the due diligence associated with Chinese activities in our markets every bit as much as we do, or at least we pay lip service to doing with American and other enterprises.

This is particularly important because I believe the Chinese have figured out a way to improve from their point of view on the old Leninist, putatively at least Leninist, line about the capitalists will sell us the rope with which

we'll hang them. Indeed, I think the Chinese figure the kinds of strategies that they're pursuing now will enable them to sell us the rope with which we will be hung.

So I will just conclude by saying I think if all else fails, if you don't do your job, and I hope that will not be the case, if the SEC under Chairman Cox, who for crying out loud ran in 1999 a commission of his own, a congressional commission that identified this as among the major problems we had with China, the patina, I think he put it, of regularity that you will see being used to try to garner funds for some very dubious entities and activities in China.

If the SEC fails to do its job, and again I hope that will not be the case, I certainly hope that Congress will take up the cudgel as it did in the CNOOC deal and both ensure that the people, the investing community of this country, and for that matter the Chinese, will from now on be assured that those companies that are coming to the U.S. market, whether they're banks, whether they're businesses of

other kinds, will meet the same standards of accountability, transparency, due diligence and so on that American companies are expected to perform at.

The alternative, I must tell you, is not free trade. It is to give China a free pass, and that is not in our interests especially in light of the strategy it's pursuing, and the implications for our security associated therewith.

Thank you, sir.

HEARING CO-CHAIR WESSEL: Thank you, and thank you for your kind comments about the work of the Commission. We appreciate it. Dr. Tadesse.

DR. TADESSE: Mr. Chairman and commissioners, thank you for inviting me to express my views on this important matter. I have put my prepared statement for the record. In addition, I would have probably ten minutes worth of introductory remarks. The broad questions posed for us in the panel today involve assessing the role of China's capital raising in the U.S. to the economic

strategy of China and its implications to U.S. economic interests.

What is the financing strategy of China? To fund its economic development. What is the importance of capital raising in global capital markets, particularly from the U.S., for funding strategy?

While Chinese firms are getting increasingly visible in the international capital markets, at this point, the role of external capital raising including from even the Chinese domestic markets to the Chinese economy is very negligible.

Rather, the dominant strategy for funding economic development is the marshalling of financial resources through an actively repressed financial system or domestic banking system. Domestic bank financing accounts for as much as 50 percent of enterprise investment in China. The remaining being sourced mainly from internal funding and capital transfer from government.

Mr. Chairman, the relatively negligible role of cross-listing in the U.S. in the larger

context of funding economic development in China, however, does not insulate U.S. economic interests from China's financial activities.

While what a nation's banking system does to a large extent is an internal affair, with China's increasing economic integration with the global economy, the institutional arrangement of the banking sector, and the manner it channels from the household to the enterprise sectors has significant implications, some harmful, to other countries.

I would like to introduce the notion of financial repression here. Financial repression refers to undue interference by governments in financial systems. A financially repressed system is a state-dominated system. In such a system, the financial sector is viewed a mere extension of the government treasury.

The Chinese financial system is a severely repressed financial system with the government strictly controlling the channeling of savings to government connected enterprises through its

ownership of banks, entry barriers, and restrictions of capital markets.

90 percent of household savings are in the form of bank savings that pay little to savers. The banking sector is dominated by the big four state-owned banks, among which they represent about 60 to 80 percent of the banking business.

The Chinese government owns about 99 percent of the ten largest commercial banks in China. Under the government's guidance, the state-owned banks direct their funds to the state-owned enterprises and other connected firms at interest rates way below the market.

The consequence of such financial repression to China itself is self-evident. It leads to gross misallocation of resources, resulting in economic inefficiency and retardation in the long run.

In addition, financial repression transfers wealth from the citizenry to the government and its connected cronies.

But the question for us here is why should we worry about financial repression in China? What are the implications to the U.S. interests? Traditionally, the consequences of financial repression have been viewed as internal. With the severity of repression in China and its increasing involvement in the global economy, the state of Chinese financial system poses serious risks to the security and economic interests of other countries, particularly the U.S.

The implications are numerous. But I will focus on two serious implications here. Namely, one, the cost advantages financial repression endows the Chinese government; and two, the breakdown of basic governance mechanisms financial repression entails.

First, the competitive implication. China has been developing unfair advantage in costs of capital that was made possible through the active financial repression it has pursued. Through direct control of household savings via its state-owned banks, the government has amassed massive amounts of

financial capital at virtually no cost for the benefit of SOEs and government-connected enterprises.

The state is providing subsidized financing through its state-owned financial institutions to its state-owned enterprises, in effect, agencies of the government, providing unfair cost advantage that can be utilized, for example, as is happening recently to acquire strategic assets around the world.

This is very much analogous to the unfair trade practices countries commonly engage in international trade. In effect, therefore, active financial repression can be utilized to develop unfair competitive advantage and China's actions are consistent with this practice.

If recent examples are good indicators of the future, Chinese state-owned enterprises with massive capital channeled through the state-owned banks under the direction of the government appear to be poised for high finance acquisitions.

In essence, China could be thought of as using financial repression as a strategic tool to build competitive advantages in its real sectors at the expense of others, including the U.S.

The U.S. should recognize financial repression in partner countries as a potential harm that can erode its competitive advantage. The key implication from this point is that financial development, that is the undoing the financial repression, has to be pursued as a national foreign or trade policy priority in engaging partner countries.

The second implication of financial repression in China involves the severe governance risk it poses to the U.S. As one of their important functions, financial systems provide valuable governance services. Banks, for example, screen potential borrowers, collect and generate information about financed projects, and continually monitor to ensure appropriate use of funds.

Government-directed banks, however, do not perform these functions adequately. In addition,

China's repressed financial system does not have the institutional infrastructure to provide adequate governance to the companies and businesses it supports.

China's financial systems suffers from poor investor protection, lack of rule of law, as evidenced by its pervasive corruption, even by developing country standards, and a highly underrepresented legal profession. By some accounts, only 150,000 lawyers in the whole of China. There is a complete lack of transparency with poor accounting standards and practices, and a critical shortage--this is very important--a critical shortage of independent auditors, accountants, analysts, other agents and institutions of information.

Inadequate governance has severe economic and social consequences as was evident in the recent corporate scandals such as that of Enron, even in the most advanced countries. The consequences are doubly severe in emerging markets such as China.

With the importance of China in the global economy, the lack of governance mechanisms in China's financial system has important implications to the U.S. economy and other trading partners.

These are the following I identified. With increasing reliance on China in international trade, systemic failure of governance at Chinese companies could disrupt the provision of strategic products and services, endangering U.S.' economic security. And here I would like to underline the fact that the governance problem I am talking about is systemwide. It's not just company specific.

Second, to the extent that Chinese companies become global employers via cross-border acquisitions, failure of governance endangers the welfare of employees from potential layoffs.

Third, in the increasingly integrated world, systemwide failure of governance could adversely affect customers and U.S. firms interconnected to Chinese companies through the supply chain.

The potential failure of governance also raises significant financial risk and security related concerns to U.S. investors in China today.

As a summary, I would like to emphasize a couple of points. China is an ally and a valuable economic partner. It should be noted that although due to the focus of this testimony, I focus on the potential risks and threats of China's financial system to the economic interests of the U.S., the benefit of economic engagement with China cannot be overemphasized.

Thus, it is paramount to continue to engage China to reform its institutions including its financial systems, both to strengthen mutually beneficial economic partnerships and to protect U.S. national economic interests.

As I pointed out earlier, financial repression provides the basis for the government's power and unparalleled influence. As a result, the government has no incentive for financial development. It is better off with financial repression rather than without it.

Hence, it is naive to presume that governments will reform their financial sectors by their own. External pressure has to be exerted to effect financial development.

These pressures may take the following forms: it could be the natural course of globalization and competition, or it could be pressures by international organizations such as the IMF and the World Bank. For example, through its strategic adjustment packages, IMF requires borrowing countries in the developing world to reform their financial sectors.

China, however, is a different case. China is a rich and powerful country and does not rely on IMF's conditionalities for its financing. International pressures of this type will not, therefore, be effective. The WTO agreements do not adequately cover areas of investments in financing although China's commitment under its WTO agreement to open up its financial sector starting 2007 could be historic opportunity for the desired reforms and remains to be seen.

Hence, appropriate pressure has to be exerted from bilateral partners such as the U.S. It is also important to note that it is to China's interest to reform and develop its financial system. The severe misallocation of capital that breeds in economic inefficiency would pose a serious threat to China's economy in the long run.

Hence, financial reform should be viewed as a win-win strategy for both China and the U.S. And thank you.

HEARING CO-CHAIR WESSEL: Thank you. Dr. Straszheim.

DR. STRASZHEIM: Thank you, Mr. Chairman. Our firm focuses on China and what China's economy and what China means to the U.S. and global economy and financial markets, so I come with a very different perspective than the two prior witnesses.

China is I think the global agent of change. It's the engine of growth. China is a growing, it's a changing, it's a complicated and in many ways confusing economy. They come from a different starting point than we do, and I think it

is very easy for us to apply our historical experience and expectations to China and come to misleading in some cases conclusions.

I want to focus on the financial markets and the capital markets today which is the real purpose, I think, of the hearings. Their capital markets, their whole financial system is frail and I think in a word "primitive." They are in the process of reforming their economy and their financial markets. We have a great deal, I think, to teach them and I think in fact China is ready to learn from us in many different ways.

Before I talk about the banks and the equity markets, which is what I want to focus on, let me just say something about the condition right now in China. China's economy has been advertised as overheated over the last 18 months. China's economy is not overheated. It wasn't last year. It's not now; it's unbalanced and those imbalances, those places in the economy which are overheated have arisen because of decisions in the command and controlled economy, and if, in fact, they followed

more market rules, those imbalances would not be there.

I think their nine percent growth or whatever number you want to use, eight, nine, ten, is really quite sustainable for a long period of time. China is long on labor and short on capital. And in our view, Beijing is not leading this process of economic reform that began in 1978. They're increasingly following it. There's a parade toward capitalism in China. Beijing figured out that there was a parade going on and decided they might as well get out in front of the parade.

And there is no turning back. Beijing will be in trouble when the music stops, and I think Beijing knows that full well. And accordingly, I believe they will do anything they can to continue this path of economic growth, to continue to bring in foreign capital, and to become increasingly engaged with us and other countries around the world. I am a believer that economic interdependence, the more the better, and so I think there is a great opportunity, and I am pleased that

the committee has focused now on the capital markets because they are so important.

With respect to commercial banking, there shouldn't be any mistake. China's big four banks aren't banks. They're lending arms of the government. They were created state-owned. They were created as lending arms of the government. That has been their role. That is their role. They dominate about two-thirds of all of commercial banking and they have an enormous lack of talent and of technology and of experience in most all of the dimensions that you and I think of when we think of commercial banks from a Western perspective.

You could walk the halls of one of these big four banks and you'd be hard-pressed to find a member of a loan committee. The recordkeeping is difficult at best. They don't have a monetary policy that is a real tool to help manage their economy, and so without that tool, and without the flex up and down in interest rates, both borrowing and deposit rates, their banking system is just utterly unlike what we think a banking system is and

should be and that's just the condition that exists in China.

As a consequence of the way they've run their banking system in the past, they have an enormous nonperforming loan problem, and they've done a couple of different bailouts in the last few years which were hailed as important steps toward reform. Nonsense. These, China's banking system and banking problems won't be improved until they make the requisite changes in procedures.

You take \$45 billion of bad loans off the books, which is what they did in December of 2003, 22.5 from China Construction Bank and 22.5 from Bank of China, put those in one of the asset management committee companies which they created for that purpose, the so-called "bad bank," and until you change the procedures, they're going to write \$45 billion of new loans which won't be bad because they're still just new.

But until they change the procedure, they're going to become bad just like the older ones. So we just need to be careful when we think

about the banking system in China and realize that it is not at all like ours. China's entry into WTO, as you well know, in December of 2001 established a schedule of different dates for which different industries had to open up to one degree or another. The banking sector was a five-year window, December 11, 2006.

They have no chance, no chance, to be ready in December 11, 2006, to compete with the Citigroups and the Deutsche Banks and so forth. Those big Western banks know that full well. So does China. And I so suspect--and it is nobody's best interests for these banks to go into China aggressively and to take market share. That's a negative sum game. Both sides know it. I think they'll accordingly move cautiously and carefully rather than abruptly.

Let me turn to the equity markets. The Shanghai and the Shenzhen, the domestic equity markets, are a joke. Everybody knows they're a joke that has ever really looked at these markets to any extent. 90 percent of all of the issues on the Shanghai and Shenzhen exchanges are state-owned

enterprises. And the Shanghai and Shenzhen exchanges were created in November of 1990, not in the image that you and I think of an equity market, which is to find a place where sources of funds and uses of funds can meet, but these equity markets were created as policy tools of the government to increase the value of the existing state-owned enterprises that they initially listed, and they have worked hard to assure that not only would that value increase, but that they would not lose control of those enterprises.

So now you've got this 70 percent or thereabouts overhang of these so-called non-tradable shares which remains and any investor that's had any experience with real equity markets around the world avoids these markets. It's no accident that last year in 2004, the Shanghai Exchange was down 15 percent and the Shenzhen Exchange was down 16 percent, the two worst performing equity markets in the world, whereas China had the best performing economy in the world.

And the reason for that is simply that the word is out and people know. So brings us to the point of IPOs coming here. No one wants to play in the minor leagues if you can play in the majors. And so there have been 23 IPOs of China companies in the last five years that have listed on Nasdaq.

The most recent one was Baidu and yet another one again yesterday. These are young companies, basically formed, started by native Chinese who came to the West, got an education, learned about our system, and have gone home to make their fortune. And they know better than to list on Shanghai or Shenzhen. They want to play in the majors and that's exactly what they're doing, and you'll see that continue.

Those who can't play in the majors will play in AAA ball which is Hong Kong. Now, Hong Kong, the Hong Kong markets are real markets. Quite good listing standards and protections. Outside directors, non-executive directors are real outside directors in Hong Kong. You know, disclosure, Internationally Accepted Accounting Practices.

These characterize American markets. These characterize the Hong Kong markets, but they don't characterize Shanghai and Shenzhen.

So from our perspective, we think you will see a continuation of the best and the brightest from China coming to list in America.

Let me make one last comment about--because I think it's quite relevant--about the currency and trade issue although I know that's not the primary focus here. I think there is a potential ruckus, a storm brewing, over the recent revaluation of the currency, and the reason I say that is China used in the revaluation, they called this change a managed floating exchange rate regime.

That was their phrase and they adopted the phraseology of the international capital markets, reference to a basket of currencies and to flex the currency up and down by as much as .3 of a percent on any given day. We've looked at this quite extensively, and while yesterday they announced that they have a basket, we've asked ourselves what basket?

If you look at any sort of rational formulation of a basket in the way that other countries around the world have formed these kinds of exchange rate regimes, you come to a conclusion that they should have made various other steps in the last few weeks and they have not.

As the financial markets increasingly realize that China has announced that they were going to do one thing with respect to the currency and, in fact, is doing something different, they will interpret that as misdirection at best or perhaps something worse, and that's counterproductive.

But, Mr. Chairman, let me stop there. I'd be happy to answer any questions you might have.

HEARING CO-CHAIR WESSEL: Thank you. I do have to note before we turn to our first questioner that I did not find as much discrepancy in your views as you indicated with the previous witnesses, but we'll leave that for questioning.

Mr. Reinsch, you go first.

COMMISSIONER REINSCH: Thank you. You've taken the words right out of my mouth on that latter point. Mr. Gaffney, you alluded in your opening remarks to the joint appearance you had with Chairman D'Amato before the House Armed Services Committee. I was distressed to discover from some of my colleagues that in that same appearance, you called me a lobbyist for Communist China or employed by entities that are.

What's your evidence for that statement?

MR. GAFFNEY: My evidence is pretty much what you have said on the public record in terms of your role as an advocate for China in the Trade Council and in your representations in this Commission and in your public appearances on television and elsewhere. I have no--I did not represent and I certainly did not mean to suggest that you are paid by Communist China for representation.

I simply suggested, as was clarified in an exchange I had with one of the members of the committee, that this is a role that I think is

completely inappropriate for a member of this Commission playing an independent and objective function of overseeing the U.S.-China relationship.

COMMISSIONER REINSCH: Well, it would certainly read differently by the people that talked to me including my wife who wants to know where all the money went that the Chinese are apparently paying me.

For the record, there is none. I must say I'm disappointed. We've attacked each other's views strenuously over the years. And actually it's been kind of fun. In this case, you've attacked my integrity, and I'm disappointed about that. I'm not a lobbyist for the Chinese. I think the fact that I don't agree with you doesn't make me one.

And I regret very much that you chose to present this in a forum, not only where I wasn't there, but where--or I have been there and maybe I'll be there again, but where you've essentially called into question my integrity.

MR. GAFFNEY: May I respond to that?

COMMISSIONER REINSCH: Sure.

MR. GAFFNEY: This is not a matter of integrity, sir. This is a matter of, I believe, a conflict of interest. And people can have complete integrity, and I certainly suggest that the other gentleman I mentioned, Mr. Langdon, who is the chairman of the President's Foreign Intelligence Advisory Board, who does work for a company that is a paid lobbying operation for the Communist Chinese, is a man I'm sure of perfect integrity.

It's simply a conflict of interest, and I would suggest that that's undesirable and regrettable.

COMMISSIONER REINSCH: Well, I think we have a disagreement over what integrity means and also over what the proper role of members of the Commission is, but I don't think I'm going to get very far by pursuing it except it say that I'm disappointed and distressed.

Now with respect to the other two witnesses, what I would really like to do and what I which I think would be most interesting to the Commission is if we could ask the witnesses from the

previous panels, several of whom are here, to get up and comment on what you've said because you really should have been on those panels since you've addressed the same issues but presented a diametrically different point of view.

I don't know--I really don't have anything to ask either of you because I'd really rather ask the other panelists think of what you've said, but I suspect we don't really have an opportunity to do that, Mr. Chairman.

HEARING CO-CHAIR WESSEL: No, we don't. If you'd like to ask those witnesses to supply comments in writing afterwards, I'd suggest that might be appropriate.

COMMISSIONER REINSCH: A brilliant idea. I would, and for the witnesses that are still here that I see lurking in the back in various places, if you--

CHAIRMAN D'AMATO: They're sitting there. They're not lurking.

[Laughter.]

COMMISSIONER REINSCH: If you would like to submit a comment on any of the three witnesses' statements, I'd be appreciative and would like very much to have it since they, in essence, disagreed with many of the things that several of you said.

Thank you, Mr. Chairman.

HEARING CO-CHAIR WESSEL: Thank you.  
Commissioner Dreyer.

COMMISSIONER TEUFEL DREYER: Dr. Straszheim, I was very interested in hearing what you said about this basket, market basket of currencies. I read an article in yesterday's Washington Post Business Section and was very surprised that--obviously the usual suspects are there, the dollar, the euro, and the yen, but I noticed as well the Singapore dollar and also that the Chinese had refused to elaborate on what weighting they would give to each of these currencies.

If you were being asked by the Chinese government how to set up these market basket, what would you advise?

DR. STRASZHEIM: Well, I think I would defer and not advise them.

COMMISSIONER TEUFEL DREYER: Go somewhere else.

[Laughter.]

DR. STRASZHEIM: They're a sovereign country and they can manage their, from my perspective, they can manage their currency in whatever way they want. They can create a basket. They cannot create a basket. It could be a rigid formula. They could change the weights of the basket everyday. It's up to them.

My only point is that--let me make two points--the idea that the Singapore dollar is there, I think it makes in some cases much sense to have the currencies of those countries that do a meaningful amount of business with China in that basket. So in our own work, we have suggested a basket before they announced this that would include the Singapore dollar, the Canadian dollar, the Aussie dollar, and the Russian ruble, Brazilian real

and so forth. Those countries that are important to China.

My broader point is, though, they use the language that's known in the international finance markets, talking about a basket and talking about the potential for the currency to float by up to .3 of a percent a day, according to supply and demand conditions with reference to this basket. That's close to a precise quote.

So as we've looked at this, what it turns out is that these currencies are moving on a day-to-day basis and yet it looks like they have really adopted a regime which is ever so close to just a new peg at 8.11 instead of 8.28. That I think is not helpful because it's misleading.

I could say all day that the coat that you're wearing is black, whereas everybody else thinks it's tan. My saying it doesn't make it black or tan. But it just causes confusion because everybody else sees it and accepts some different definition.

COMMISSIONER TEUFEL DREYER: But this leads me to a larger question, and that is how does the People's Bank of China manage the economy? I mean is this what's going to decide the value of the yuan? And help me to understand this better.

DR. STRASZHEIM: Well, I--

COMMISSIONER TEUFEL DREYER: Yeah, I know-- two minutes or less.

DR. STRASZHEIM: Well, quite frankly, none us know. And People's Bank of China is not about to tell us. What I find most sort of unsatisfactory when I look at China is not that they don't have an independent monetary policy, although I think an independent monetary policy has been proven around the world to be quite useful, but in some sense they hardly have any monetary policy at all, in the sense that they don't have a banking system that allocates credit according to kind of risk-reward criteria: the good applicants get the credit and the bad applicants don't.

And so to flex the interest rates up and down, to sort of modulate the economy is kind of a

tried and true way. People's Bank of China just doesn't have that tool available, and accordingly it is really quite hamstringing in the sense of their ability to control growth, inflation and all the other variables that they would like to be able to influence.

MR. GAFFNEY: Could I make a point on this? I would certainly defer to my colleague's expertise in the economic aspects of this. Just looking at it from a strategic point of view, I don't have any clearer idea than he does as to how this black box is going to operate, but I do think that factors that will be involved in how it operates are corruption, and the effort to jujitsu, if you will, this pressure on China to change the value of its currency into a new instrument for rewarding its friends and punishing its foes.

And I think has been indicated, the people who are likely to be in the basket are countries that are important to China. What does that mean? My guess it means that you'll see it used to the

detriment of the United States when it serves its purposes.

COMMISSIONER TEUFEL DREYER: Dr. Tadesse.

DR. TADESSE: Yes. On this point, what I want to add is that countries have a choice to adopt a flexible exchange rate system or a fixed rate exchange system, and fixed rate exchange system has legitimate reasons governments use it for. But one thing we have to keep in mind is that China is a command economy and so the government's use of fixed exchange rate regime could be excessive and this is basically an extension of what I alluded to earlier as the government wanting to have its hands in every financial affair including the bank sector as well as the exchange rate regime.

So another way I want to look at it is that while domestic banking repression transfers wealth from the citizenry to the government, this fixed exchange rate system, when it is used excessively, could be used as expropriation of wealth from other countries to China. So they complement each other. So in that sense, we should be concerned about it.

COMMISSIONER TEUFEL DREYER: Thank you very much.

HEARING CO-CHAIR WESSEL: Thank you. Dr. Straszheim, you just said if I could paraphrase a bit, that it's not really a float; it's a peg or a new peg. And I think part of what we're dealing with here is problem of terminology where we want to overlay our terminology on the Chinese, the incompatibility of our markets.

We, you know, want them to address the common rules of trade and ideology as it relates to free trade and comparative advantage when we have a market economy on one side and a non-market economy on the other side.

As part of that terminology, I'd like to know why we consider these to be bad loans? And I'd like to hear from each of the panelists. Bad loans that have brought an economy to the point where it's growing at eight, nine, ten percent per year; loans that have helped build up a military infrastructure that is becoming a world-class military force. Are we the only ones who consider these to be bad loans

when, in fact, they are use of governmental and other financial tools to advance its own interests?

Mr. Gaffney?

MR. GAFFNEY: Well, I think bad loan is a technical term, but I'm not sure.

HEARING CO-CHAIR WESSEL: It may be to us, but they're looking at it differently.

MR. GAFFNEY: No, I think you're on to something. In terms of the Chinese government's, as has been now acknowledged, remaining a command economy, despite all that we hear about in this building and across the Hill and downtown, that it's now no longer Communist. In fact, I've been discouraged from even calling it Communist, though they call it Communist, and that it's a free enterprise operation, when it is clearly not.

Now, it may be something approaching a fascistic economy, but it is certainly not a free market economy. And as with fascism, I think the state finds ways to use capitalism or quasi-capitalistic operations to underwrite activities most especially of the kind you've highlighted, that

are bad for us, the strategic purpose that I was talking about earlier. This military build up, this acquisition of influence in not only Latin America and Asia and so on, but here.

Are those bad loans? Are those loans that will not have a very handsome return on investment for China's longer-term strategy? And come at our expense? My argument is in that sense no, they're not bad loans at all. I think in the technical sense, meaning you're likely to get repaid with interest, they would probably fall outside of the realm of good loans.

HEARING CO-CHAIR WESSEL: Understand. Dr. Straszheim.

DR. STRASZHEIM: These are bad loans in the sense that if you look at the books of these state-owned enterprises, they've not booked a profit that would allow them to pay the seeming interest to make them whole, so in that sense, I think they are bad. But it is an important point I think that we come from a different perspective than they do.

Our system is different. Their economy is part command and controlled economy, part market economy. It's mixed. I'm optimistic from the point of view that the command and control portion of the economy is declining and the market portion of the economy is rising. If you asked Starbucks who has a couple hundred Starbucks over there, selling decaf lattes for 3.35 a cup, they would tell you in downtown Beijing, they would tell you that it's a real market economy to them.

On the other hand, the CNOOC loans, these weren't loans. These were zero interest loans. These were loans that ultimately would have to not paid back at all. So in that sense, there's a lot of confusion here.

HEARING CO-CHAIR WESSEL: Just like the loans that I give to my children it sounds like.

[Laughter.]

DR. STRASZHEIM: I'm sure.

HEARING CO-CHAIR WESSEL: Dr. Tadesse.

DR. TADESSE: I think the confusion comes because we are using our standards in trying to

understand what goes on there. In a way as I suggested earlier, in the strict sense of the word, these are not loans, these are grants. And so a grant, it's a gift, so there is no expectation of payback. But because these are banks, and banks are in the business of lending, then we also have to use our standards, the standards of banking everywhere-- if they are granted in the form of loans, and when they are not paid up, they then would qualify as bad loans.

So it's a confusion of terminology. In a way, a confusion of culture, different culture. But this also leads us to another question: what's the advantage of this government ownership of banks and therefore government direction of credits from the Chinese perspective?

There's a debate over here. One view says that the government ownership is completely bad, but my view is a little different in the sense that from the Chinese perspective, what they're trying to do is trying to catch up with the West, and so the marshaling of the resources is not intended for

quality, quality of investment, it's rather building up industry and whatever they're lacking in.

Well, of course, there is the bad side in this because, as you know, that screening and monitoring mechanism in banking, you know when banks advance credit, they screen borrowers, they evaluate the risk/return tradeoff. That is not done here, and as a result, down the road, what you bring is inefficiency, but that's not their main concern right now, which is quantity, not quality.

So that's my thoughts on this.

MR. GAFFNEY: Commissioner, could I just add quick points on this?

HEARING CO-CHAIR WESSEL: Yes.

MR. GAFFNEY: In response to what was said a moment ago, it does seem to me that if we're looking at a mixed economy with some being private sector and some being command and control or fascistic or whatever you want to call it, to turn to the topic of this hearing, is the effect of American investors purchasing the stocks they're allowed to buy, ten or 15 percent I think on

average, of these state-owned enterprises the way China envisions perpetuating its otherwise unviable command and control sector?

I think that may well be the case and along with it the activities that we would not consider to be good or certainly good loan kinds of activities.

And the second is I think it really comes to the point that I was trying to speak to earlier: when we say these are banks, when they come to market dressed up like they're banks and nobody knows what's in their portfolio, the would be investor has no transparency, again, on what's this black box about, it creates, I'm afraid, a false confidence, a false expectation that it is going to be a bank, that it will return investment, it will otherwise be a wise thing to hold in portfolio.

I'm not sure that's true and that's why I think this hearing is important and the transparency that I hope you will encourage is so important.

HEARING CO-CHAIR WESSEL: Appreciate that.  
Chairman D'Amato.

CHAIRMAN D'AMATO: Thank you very much, Commissioner Wessel. First of all, I want to thank this panel. This panel is kind of a seamless web from end to another in various ways. I want to commend Mr. Gaffney for your long services on behalf of the nation. I remember working with you in the Senate many years ago, you with Scoop Jackson. I started with Robert Byrd doing a lot of things in the Armed Services Committee.

And it is somewhat different in your perspective from the previous panel, much of which they said I agreed with as well, and that may be contradictory. So I just want to point out to Commissioner Reinsch, that if we're going to have written comments from the previous panel on the statements made by this panel, that we can at least then provide those written comments to this panel for their written response, and that I think would be fair. We'll try and do that. We won't continue that on ad infinitum, but at least two rounds would be, I think, good.

[Laughter.]

CHAIRMAN D'AMATO: I would like to say that in terms of the banks, it's hard for me to really envision these are really banks as institutions that we understand as banks. What you all are saying is that they are lending arms of the government. I think no one would really dispute that.

In a command and control economy, essentially command and control, maybe shifting in some ways, but still command and control and highly corrupt, I think there's a general consensus on that one, the question we have then is how do we help reform this system or do we just ratify the system? It seems to me that right now front and center of this whole IPO situation raises that question. How do we handle the IPO situation? Are we going to ratify the system as it exists or are we going to help reform it?

It seems to me--and I'd like the views of the panel on this--that we've got to find a way to put the same kind of standards of exposure of transparency and all of the things that we require of our own offerings in the New York Stock Exchange,

impose them on these banks, and that means, it seems to me, we've got to find a way to get into the details of the loan portfolios. What are the loans that have been given? I mean loans given to Sudan, Iran? What kind of an institution do we have? Why? Because we just went through a bubble where millions of Americans were defrauded through a high tech bubble.

I don't want to see us sit around and watch millions of Americans get defrauded on a China bubble, and we're in the position now I think that we can move in the direction of strong, stringent transparency in this.

There was a mention--I think you mentioned two banks and NPLs. I think you mentioned the Bank of China and China Construction Bank.

DR. STRASZHEIM: Yes, sir.

CHAIRMAN D'AMATO: I've got a rating system here that we've gotten from a reputable Wall Street firm that shows all of these Chinese banks are way below par compared to banks, international banks. International banks rate at the average of C plus.

There is no Chinese bank that rates even a C minus. They're all either D or F or E, and those two banks, those two banks, Bank of China is a D minus. China Construction Bank is an E plus.

Now, it seems to me if those banks are going to come to our market with IPOs, our investors ought to know why they're being rated that way? Would you recommend that your cousin invest in these banks given that kind of rating?

So it seems to me--I'd like your opinion on this--that one way we can help move the system, reform the system, is not ratify IPOs which are going to have the potential of risk for our investors, for our teachers, for our policemen, for our firemen, for those retirement systems and mutual funds. We can do better than that. It seems to me in this case, we are well advised to insist on a kind of a transparency that would be equal to them coming on to our New York Exchanges.

Let me get your comment on that. Mr. Gaffney.

MR. GAFFNEY: Well, I agree with you up to a point. I think it is certainly true that free pass that I was talking about in my testimony is ill-advised. We are, I think, doing neither the Chinese nor certainly American investors any service by pretending that these are banks, you know, credible, well financed, well managed banks. I mean was listening to my colleague here talk about what amounts to these sort of poor banks.

They don't have technology, they don't have--let's be clear. The Chinese are very adept at business practices that serve their purposes. This is not because they can't figure out how to bank that they're running banks this way.

And what makes this particularly important is I really believe that they have figured, based on past experience, both with banks. One of these Chinese banks I think went to Hong Kong and got \$1.9 billion just recently. They've got two more that as you say are coming. One that they think, I think both of them, I'd expect, may get as much as \$5 billion out of their capital markets.

This would reward them. But the point at which I think I disagree with you, and respectfully, is I'm not sure that it's enough given the character of the Chinese Communist government that owns these banks, and the use that they put these banks to, to simply say they ought to meet the same standards as American banks. I'm not sure that we have the right to look in the loan portfolios of American banks. I just don't know enough about that.

But I certainly think you're right. We do need to be able to see who's held in portfolio and what is being done with the money? Because the alternative is to simply be writing checks that will indeed turn into new bad loans and a lot more bad activity. You can bet.

DR. STRASZHEIM: I think we ought to have, Mr. Chairman, I think we ought to have a great deal of confidence in our own capital markets and the collective investment judgment of the American investors who are potentially going to buy these IPOs.

If these banks try to do IPOs here, they're going to have to go through the same process, the same kind of disclosures that anybody else does to come with an IPO, whether it be from China or Germany or anywhere, and I think Wall Street will do quite a good job at looking at these IPOs and will be able to decide how to price them, and in the last analysis the pricing of these IPOs and what happens to the value of these different securities is up to the investors.

It's not up to the, it seems to me, any government agency and my own view is that these banks are nowhere close to being ready to stand up to Western scrutiny. In 2003, China Construction Bank and Bank of China were talked about in China to do IPOs in 2003. Didn't happen. Well, maybe we'll get them done in 2004. It didn't happen in 2004. Well, maybe we'll get them done in 2005, and now it's probably--it's not going to happen in 2005 and maybe it will be 2006 and mainly only in Hong Kong.

So I think the markets really work quite well, and we are weeding these potential issues out.

DR. TADESSE: The question is how can we help Chinese to reform its banking sector in general, and then particular with respect to the IPOs. Now from my view, I think the key ingredient for reform will be the opening up of the banking sector to foreign competition. That would serve as a key catalyst in both improving practices as well as the concerns we have.

It's competition and privatization. I do not think that--I would agree with my colleagues here that rushing into allowing IPOs of state-owned banks is not to the interest of the U.S. I think we have to first ensure privatization and competition.

But with respect to introducing transparency and the like for IPOs, not only IPOs of banks but IPOs of non-financial institutions coming from China, it seems to me that the current regulatory regime where you basically look at the checklist of disclosure may not be adequate in the sense that here my point is that we should realize that this is a command economy, and in a command economy what we have is all economic agents

including auditors and accountants and agents of information are under guidance from above.

And so where you have this, you know, complete breakdown of governance or transparency, the way the disclosure, the manner in which the disclosure is produced, is much more important than, you know, simply a checklist. There are some scandals, such as China Life, for example, which alerts us to this possibility.

And so I think a strengthening or rather changing the manner in which the SEC goes about disclosure, ensuring disclosure compliances would be one area we have to look into.

CHAIRMAN D'AMATO: Thank you very much. I think that's quite important, the SEC. I must say, though, that I'm not sure--I don't have the kind of confidence that is expressed here in terms of Wall Street. I mean let's face it, what happened earlier with Sinopec I believe was being marshaled through by a Wall Street firm, and they get big fees. So anything they can make a market on and take a fee in and then they hit the road afterwards. I think

we've got a lot of expertise in bringing, you know, a pig's ear to make it look like a silk purse, and you know, then there's a lot of people holding the bag later and find out it's not a silk purse.

In any case, I just want to also mention for the record that the rating I mentioned on Wall Street was a Moody's rating. These are Moody's ratings, and we'll put that in the record.

I just have one quick other question. You mentioned the basket of currencies. Do I understand that you have actually created a couple of model baskets of currencies and then show how they would move as opposed to what the Chinese are saying with this mysterious basket?

DR. STRASZHEIM: Yes, what we've done, Mr. Chairman, is tried to estimate in our own way what we think the currency would have done since the revaluation of 2.1 percent on July 21, according to what our analysis suggests would be in a basket if, in fact, that's the way they were managing their currency.

So we've looked at the things that would be important, which are trade flows and foreign direct investment and so forth, and created a variety of different sets of weights looking at the euro, the yen, the Singapore dollar, and various different ones. And then accordingly calculated what the daily move in the currency, in quotes, "should," have been were they using that basket and compared that to the actual new announced rate which they said they were going to do, and in fact are announcing on a daily basis.

And our finding is that there is precious little correspondence.

CHAIRMAN D'AMATO: Well, can you submit for the record your findings on that or can you tell us what the differential is from what you know so far?

DR. STRASZHEIM: I'll be happy to. I'll submit that. But it's material. It's material enough. I'll be happy to submit it for the record, but it is material enough to lead us to conclude that this basket concept is being in our sort of perspective kind of honored in the breach.

CHAIRMAN D'AMATO: Thank you. Very, very interesting.

HEARING CO-CHAIR WESSEL: Thank you. Vice Chairman and Co-Chairman Robinson.

VICE CHAIRMAN ROBINSON: Thank you. Thank you, Mr. Co-Chairman. I just wanted to in effect echo the chairman's skepticism that the marketplace is necessarily going to serve us in this particular endeavor quite as you think it will in terms of just vetting those state-owned banks in a manner that ensures that the investor has adequate information to make, as they say at the SEC, an informed judgment--the example that the chairman provided of Sinopec which came to market for I believe 3.4 billion in June of 2000.

We've heard testimony that two of Sinopec's subsidiaries have I think more than once, been sanctioned by this country for the proliferation of weapons of mass destruction, and in our preparation for these hearings, we made an effort, maybe it's not the definitive effort because we're moving at rather high velocity, and so I may need to stand

corrected, but we made an effort to look at the prospectus of the Sinopec IPO and its other filings to see if in the appropriate risk section the investor was made aware that two of this entity's subsidiaries were at least reportedly involved in proliferation related activities.

And I think it's the case, and, of course, I'll be interested to hear if any of the panelists have a different view, that the proliferation of weapons of mass destruction in this environment as one of the two most pressing security issues of our time, along with global terrorism, is not viewed as a material risk that should properly be disclosed to investors, and we did not, and again this may not be a definitive statement, but we did not find any reference to these events in those filings.

So, again, we're not dealing with Belgium or Argentina here. We have a particular set of concerns. When it came to, you know, even CNOOC, what happens if the Congress had not played a more robust investigative role in scrutinizing that transaction? Would we have learned about Mali Corp.

and the rare earth minerals that have such military relevance to this country? Would we have learned about the dual use potential, potentially dual use technology such as cavitation technologies? And would we have learned the breathtaking level of no interest in below market loans? 13 out of 16 billion in external financing that was supposedly on the table to enable CNOOC to proceed when it clearly wouldn't have had those kind of resources otherwise.

So, in other words, it took a lot of extra debate, well beyond Wall Street variety, to come up with the facts of the case, and we know what the epilogue was.

So I share the chairman's concern that folks don't advertise proliferation activities of their subsidiaries--big surprise. And we have the added burden that sometimes we generate intelligence information that's unknowable by the public or even by the investment banks or others that are performing this due diligence, and I don't have a ready answer.

All I'm suggesting to you is the capital markets are a particular type of problem. You know your money and my money and the money of the people observing this hearing were not implicated in this CNOOC Unocal transaction. But they may well have their retirement dollars and other dollars implicated here because they'll not know that their mutual fund and pension fund and 401(k) plan and other managed portfolios have purchased Bank of China or the China Construction Bank, just as they might not have had a full awareness at Harvard that they owned a lot of PetroChina when they later found out its robust involvement in the killing fields of Sudan.

So we need to think about, it seems to me, and I'd be interested in your view on this, mechanisms that go beyond standard operating procedure here when it comes to those Bank portfolios. We heard testimony earlier today that said it's just too damn hard to look at what could be thousands, tens of thousands of names that, in fact, are the customer base of Bank of China and the

Construction Bank. Who has time to, and would they understand what they're looking at anyway?

Those are legitimate questions as well, and I understand that, but I'm just trying to see or just to probe you a little further on whether you fundamentally believe that the magic of the marketplace, as President Reagan would have called it, or the standard Wall Street drill of due diligence is indeed adequate to ferret out, lay out, delineate and understand the true activities that are being funded by these institutions that, as Mr. Gaffney and others have indicated, would be potentially appalling to the American people were they to know that their hard-earned dollars were implicated? Do you have any views on that?

MR. GAFFNEY: Is that a directed question or do you want all of us to comment on it?

VICE CHAIRMAN ROBINSON: Well, I just thought--

MR. GAFFNEY: If I may leap into the breach here. I think this question that the chairman has raised about a China bubble is directly relevant to

this discussion. The market cannot work--let me repeat that--the market cannot work without information. And to the extent that we do see nontransparent companies coming to market, it's impossible for investors, certainly individual investors, and I think probably most institutional investors as well, to make informed decisions, to understand material risk.

As you know, Mr. Vice Chairman, the SEC has begun calling some of this global security risk which has real financial repercussions. How can they assess that if the conditions that give rise to that risk are not disclosed? And they're not being disclosed, as your study of this has indicated.

I just have to say that I worry in addition, and again I don't want to sound as though I'm impugning anybody's integrity, but there are conflicts of interest at work in this area as well. You have qualified foreign international investors, QFIIs, that do get into the markets that Dr. Straszheim has said nobody would want to fool with, and through their investments, you do have

institutional investors finding they're holding, if they have the wherewithal to look for it, in portfolios some of the A shares and things that would be turning up there.

You have companies, as has been mentioned, I think, by the chairman, that have a very profound vested interest in successfully bringing to market in America these sorts of state-owned enterprises, and it's not to say they don't have integrity when they do it, but does it affect how intensively they do due diligence? I would think that's not an unreasonable guess.

Finally, I mention in my testimony something that I just, and urge this commission to take a hard look at, because again as part of the larger strategy that worries me at least, the possibility that unwitting American investors could become, in effect, suborned, could become invested, even though they didn't know it, in China and in these otherwise unsustainable state-owned enterprises could give rise to a China lobby that

would make what we've seen in terms of coopted businesses in the past pale by comparison.

There would be no more talk of sanctions. There would be no more talk of, you know, the kinds of pressure perhaps on China that might jeopardize people's pensions, people's nest eggs, because unbeknownst to them they wound up being invested in places that happened to be supporting proliferation or terror or other activities inimical to our society.

Again, this is something I do not believe for a moment that veterans, firemen, policemen, you know, state and local public employees, teachers, would want to have any part of. And yet they will not be able to do otherwise unless they know more, and without knowing more, the market cannot be a guarantee against it.

DR. STRASZHEIM: Can I say something quickly on this? I think it would not be unreasonable to think about some additional disclosure requirements when, in fact, we're talking

about IPOs of state-owned enterprises as opposed to IPOs of just conventional private sector companies.

Now, in fact, as I think it as I speak, you could require some additional requirements and then in the case that was just a private sector firm, those requirements would be moot, but they would be relevant only in the case of a state-owned enterprise. Nothing wrong with that it seems to me.

Two other things. The financial markets with respect to Mali and the rare earth minerals, I think the financial markets were well aware of that before CFIUS and all of this furor kind of began. Sinopec IPO in 2000, as you well know, in the risk statements of when various prospectuses, there's a standard litany of things about management and market conditions and industry, and so forth, and it's not at all obvious to me that there's--maybe there should be--some additional requirement, but this happened in 2000, not after 9/11, and I'm not sure we should be too critical about what we did know or what we didn't know at that time.

The investment by qualified foreign institutional investors in the Shanghai and Shenzhen markets in A shares, I believe in most of those cases, the rationale is not that these investments are going to be especially good investments, but rather that these are investments really in relationships in the future. And I think that's the case of the investments by the biggest banks in America buying into the big four banks.

I think the big four banks are dinosaurs and I believe those banks who are investing in them likely see them in some similar way, but they would like to get in the door and make those relationships for some unknowable potential future gain.

HEARING CO-CHAIR WESSEL: Thank you. I apologize. We're going to have to cut this line off and turn to Commissioner Mulloy for the last line of questioning.

COMMISSIONER MULLOY: Thank you.

DR. TADESSE: May I respond to his question?

HEARING CO-CHAIR WESSEL: Yes, a quick response.

DR. TADESSE: I agree with the points you made, that markets are not equipped to assess the types of risk you alluded to. And that's not particular to China. Even within domestic investments, if you value two banks, one providing, exposing the country to certain types of risks you mentioned, and the other safe on that regard, the evaluation differs based on the monetary returns, not on the security concerns, on the basis of security concerns, even for domestic investments.

So then where do we go from here? Well, the question you raised is in the context of IPOs. But now one point we have to be clear is that the advantage of IPOs for the constituents in the U.S. is mostly to investment banks and not really for the investing public because the investing public has many other menus or options to expose itself to China's investment opportunity. That's a risk-return tradeoff.

They could use pension funds. They could use mutual funds and other options. It may be, I think, prudent, I think, or maybe operationally simpler to actually control the investment strategies of pension funds and mutual funds rather than to burden the financial markets here with additional requirements of going through new types of disclosures. So that avenue also should be looked into, probably discourage IPOs if they are uncertain, if the use for which their plan is uncertain, and encourage or rather focus on the other options such as pension plans and mutual funds through which U.S. investor might be exposed to Chinese investments.

HEARING CO-CHAIR WESSEL: Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Commissioner Wessel. This is directed toward Dr. Straszheim, but if the others want to comment. Let me just spin out a little bit what I think may be, and then help me think through. China went through a bad couple hundred years. They were a great

civilization, went through a bad time, and they were figuring, you know, people were ripping off parts of them and drug wars, making their people take drugs, you know, the British and the opium wars and all this.

So they had Mao Zedong came to power in '49, they wanted to change this humiliation that they feel they went through, which I think is somewhat--now they talk about this term "comprehensive national power," which I think means political, economical and military integrated. And they weren't able to build it under Mao Zedong and the Communists. Deng Xiaoping pushed for a different approach to how to do this, and he began to talk about, well, let's move forward technology, science and have the foreigners come in and help us do it.

And they reached out to get foreign investment. They reached out to become part of the global economy, still being a pretty centrally directed political system. WTO entry I see as part of that because essentially what they do then, if

the U.S. could take away MFN and instead of a 2.5 percent tariff, the Chinese have a 40 percent tariff, then the foreign investors aren't as likely to want to go into China to invest because a lot of it is shipped out.

60 percent of Chinese exports are from foreign invested companies. So WTO is another part of getting this system right, and they got it. They do have a strategy of pillar industries. There are certain industries they think are very important to build your comprehensive national power. Automobiles is one of them. I think aerospace is another. Semiconductors is another.

Now, in the earlier panel, Dr. Bottelier and Professor Meyer both mentioned this phenomenon of they did a lot of consumer lending for automobile purchases in China, and then there was a lot of money then invested in to building automobile plants in China, investment building. Suddenly that went out and they're not selling as many automobiles in China, but now they've got the industry there so

they're going to export more automobiles and auto parts and other things.

Now, you see Adelphi in trouble and GM in trouble. So what I'm thinking is, and then one more thing, the exchange rates, and you Dr. Straszheim say, well, they're a sovereign country, they can do what they want with their exchange rates. That may have been, but once they're in the WTO and the IMF, they have certain international obligations that don't let them do what they want with their exchange rate system because now they're part of a system where they're not supposed to be manipulating their exchange rate to gain trade advantage.

So I see all of this kind of--they kind of have an integrated view of how they're moving themselves forward, and we don't. We're kind of ad hocking everything. Well, we'll go after them on exchange rates or we better deal with the safeguards on textiles, but we have no comprehensive vision of what we got here. This is not Europe. This is a different kind of entity, and our policies and our vision of how to operate in a global economy is

quite different than what we've got here. And I'm just wondering is that right?

Secondly, is that something that the United States really should begin to address at a lot of urgency, how do we nationally deal with this issue we've gotten ourselves into? So Dr. Straszheim.

DR. STRASZHEIM: I'm not sure where to start, Mr. Commissioner, on this. It is clear that after the Cultural Revolution from '66 to '76, which was arguably the most damaging and devastating social experiment in the history of the world, ended and they started the reform and opening up process in 1978, with Guangdong Province basically being a testbed to see if they could kind of toy around the edges with a market economy and so forth, and then if it worked, then do a little more. It's kind of gone national now. That's kind of the way I would describe what's happened.

They clearly do have--you called them pillar industries. They have a host of industries which they regard as strategically vital. The oil industry is a good example of that. CNOOC,

PetroChina and Sinopec are the three main players. Beijing is in charge. The markets aren't in charge, the markets are not going to be in charge. Western involvement is going to be around the fringes rather than at the core of energy and oil sector in China.

Their lists of strategically vital industries I think is much wider than sort of ours would be in some sense. I was quite frankly surprised during the whole CNOOC episode. Right in the middle of that China announced new regulations limiting foreign investment in the steel industry.

COMMISSIONER MULLOY: Yes.

DR. STRASZHEIM: Right in the middle.

COMMISSIONER MULLOY: I remember that, yes.

DR. STRASZHEIM: And I was kind of amazed at the silence, quite frankly, that people didn't jump on this more as the non-level playing field kind of issue, but whatever.

COMMISSIONER MULLOY: We spoke about it.

DR. STRASZHEIM: I mean I think they are going to continue to have this perspective, and we don't, but I've looked at a lot of the Five Year

Plans that China has developed all the way back to 1949 or '50, whenever the first one came out, and I must say I don't think that is an especially effective way to try to run an economy. I'm much more comfortable with the invisible hand than with the iron fist, but China clearly has part of the economy that is command and control economy, strategically vital, they're not going to change that.

And part of it is market economy, not that important, not damaging, let the market forces work, and I believe that the more involved we become with China over time and their involvement, their entry into WTO will encourage the shrinkage of the command and control portion and the increase of the market portion, and from my perspective, that's a good thing.

MR. GAFFNEY: Well, maybe, maybe not. I'm concerned that one thing that I think perhaps inadvertently was left out of your synopsis was the emphasis that Deng Xiaoping and the 16 Characters formulation placed on everything being subordinated

to the military. He was indeed interested in getting Western and outside help to build China's technology base, its scientific capacities, its industrial capacity, but it was in service of the military which brings me back to the strategy that I think is at work here.

You said it very well. I've used the same formulation in fact. They've had a bad couple of centuries. But in a society, in a civilization that prides itself on having been the center of the universe for millennia, it's coming back to its rightful place, and Deng's policies and those that have been I think advanced subsequent to his departure from the scene are very much of a piece with that and worrying for that reason.

It is of a strategic character, not simply of a commercial how do we retool our industrial base. Could I just say in that regard, there were several things that I didn't want the Commission to miss that I think were important acknowledgements perhaps by Dr. Straszheim.

One, the market did understand, he says, that we were 88 percent dependent upon Communist China for rare earth minerals. But it was unconcerned about that. And as you've said, I think, had it not been for a hue and cry being raised by Congress, this deal probably would have gone to the high bidder including the last source, other than Communist China, as a practical matter of these rare earth minerals which are critical for our industry.

He mentioned that QFIIs are doing this not because it makes business sense in a financial return in the near term on investment, what investors might reasonably think is going on, but rather it's getting into the game. It's building future relationships. Bingo. That's what I'm talking about. It is the co-option of our businesses into believing that if only they will play ball, whether it makes sense financially in the short term or not, they will get some bonanza down the road.

Michael Ledeen, a former member of this Commission, is fond of saying, as I'm sure you've all heard, we've been looking for the illusive China market at least since Marco Polo's day, and it's still over the horizon, and yet QFIIs and people who unwittingly are investing through them or getting into their portfolio the products that don't make financial sense in the short run, but will be good for the long-term business relationship of at least the QFIIs are not necessarily the same thing as sensible business plans, let alone ones that would really be acceptable to those investors.

And in conclusion, I would just say I think that it is time, and I really again am grateful for the existence of this Commission, it is time for people to say wait a minute, these theories that illusive China market will actually pan out, that they're doing all these things like engaging us to help build up their auto base so that we will be able to sell to their market--uh-uh--so they will be able to sell to our market and so on, get a hard

scrub and a second opinion. So, again, I thank you for doing that.

DR. TADESSE: In response to your question, I take a little slightly different view in that I see prospects for China to come into the world economic good partnership, and my indications are the amounts of or the extent of reform that has taken place since 1980 up till now, the expansion of the private sector although it was not at the pace we wanted it to be.

And so there is prospect, and then of course there is also hope that with the joining of China with the WTO and, of course, its commitment to open up its markets to international competition and the like, that is also another indicator that strengthens my belief that China will come into the fore.

Now, however, it seems to me that the financial sector, the reform in the financial sector, is the last straw, or it is the key. Why I do I say this? The IMF and the World Bank had been in the business of forcing governments in third

world countries to reform their economy including financial sectors. From their experience, what you see is it is pushing these countries to open up their banking systems, their financial sector, that is the last hurdle.

Basically governments come to believe that the banking sector is an extension of their treasury, and they don't easily give it up. And so I think our last push in terms of basically pressuring China to open up and to come the arrangements we want would be to pressure it on the financial reform. By that I mean privatization, change of ownership, competition, particularly foreign bank competition. The government's power basically is from the control it has on financial resources through the banking system.

You take that away, then we I think will be on the right track.

COMMISSIONER MULLOY: Thank you very much.

HEARING CO-CHAIR WESSEL: Thank you to the panel. We appreciate your time and all your service to us this afternoon. We're going to do a shift of

panelists. Mr. Chao is here to begin, and we'll move accordingly.

[Whereupon, a short break was taken.]

HEARING CO-CHAIR WESSEL: Thank you. We're running late this afternoon. We appreciate, Mr. Chao, your being here. I know you have had a long road to get here, long flights to get here, I guess. And had planned on being on this morning's panel.

Mr. Chao is partner in charge of O'Melveny & Myers Asia practice. During his 25 years of practice with the firm, Mr. Chao has been engaged in a broad variety of transactional matters. He is responsible for establishing the firm's China offices and was stationed in their Shanghai office for seven years.

He's currently engaged in their general corporate practice with an emphasis on cross-border and Asia matters. He is a recognized authority on China and has extensive experience advising clients on China matters. He has advised clients from many sectors in connection with their investments and operations in China.

In the U.S., Mr. Chao has advised clients in connection with a variety of transactional matters including venture investments, corporate finance and M&A activities and we're pleased to have you here this afternoon. We are going to be fairly strict in our time requirements. Any prepared testimony will be submitted for the record and will be included and seven minutes, if appropriate, for your oral testimony, then questions.

Thank you.

MR. CHAO: Thank you, Mr. Co-Chairman. It's a pleasure to be here. Thanks for honoring me with an invitation to speak. The beaches of Greece were getting old so I decided to come out and join you.

HEARING CO-CHAIR WESSEL: Some judgment questions there, but--

MR. CHAO: I have submitted some written comments and so I'm not going to try to go through all of those and I suspect much of what I covered in my written comments were covered this morning as

well by other speakers, and I don't propose to duplicate their remarks either.

I will try to pick out a few key highlights from what I submitted to you to perhaps illustrate some of the changes that have occurred in China's participation in the international capital markets in the last year or so. I know that the Commission held a hearing on the subject in April of last year. And I believe that there are some significant changes that have occurred since then that may be noteworthy for the Commission.

First, to self-introduce a bit, as you said I'm the head of our Asia practice. O'Melveny & Myers is an international law firm with a very large presence in China. We have offices in Shanghai, Beijing, and Hong Kong, and I spent seven years in Shanghai building up our Shanghai presence before moving back to Silicon Valley about four years ago.

So we've been involved in the thick of much of the foreign direct investment as well as a lot of the IPO activity more recently that's been coming out of China. In particular, last year, we were

involved with Shanda which was the largest, a very large online gaming company out of china that did a Nasdaq IPO, the most successful U.S. IPO of the year last year.

This year we were involved with the Focus Media IPO on behalf of the underwriters Goldman Sachs and CSFB which was the largest Chinese IPO on Nasdaq to date.

The numbers for China's capital markets participation are staggering. I won't go through those numbers because I'm sure you're familiar with those. I will also skip the discussion of why Chinese companies are coming abroad since I think you are probably familiar with those as well, but I would like to point out that because of the fact that the numbers are so big, that this is now becoming a two-way street in terms of benefits for the United States in China, and what I mean by that is that if you look at some of the statistics the investment bankers are telling you that Chinese IPOs now are the second-largest source of fee revenue for the investment banking community in the last year,

and that they are in fact more important last year than the European IPOs.

So, and in addition, therefore, it's fair to assume that the trading volumes of Chinese companies in international capital markets including U.S. capital markets will be very significant in the future both in terms of overall volumes and also in terms of generating fee income for the financial community in the markets where they trade.

So I think it's important for us to look at this also from the point of view of the importance of the U.S. capital markets globally and their role in taking on the most important financial assignments globally including some of the most important companies that come to market and whether the United States is going to get that business going forward in the future, whether that business is going to go somewhere else.

The pace of Chinese IPOs coming out in our estimation is accelerating. I believe that it's probably the largest pipeline of Chinese IPOs since Chinese IPOs have started to come out

internationally. This is based partly on anecdotal market evidence. It's partly based upon our own pipeline, but we believe that the pace will only accelerate.

So I think it is very possible that given the number of Chinese companies projected to come to market that within a few years, Chinese companies will constitute a very significant and increasing portion of market capitalization of all international capital markets, and that the trading volumes of these Chinese companies will be very significant, and so that this is important for the U.S. financial markets.

Now, I would like to bring to the Commission's attention two very important trends that have occurred since the April hearing that the Commission had last year, which I think have a bearing on many of the subjects that have been discussed today.

One is that there has been a mark trend away from U.S. listings by all non-tech Chinese companies in the last year. So that, in fact, much

of the discussion that was I heard this afternoon might be mooted in a sense that a lot of these companies will just simply not come to the United States markets.

They will not list in the United States, and I think the reason for that is partly out of concern for the burdens of Sarbanes-Oxley, partly out of concerns of liability of shareholder suits, and we have seen a large number of shareholder suits against Chinese companies in the last year.

And so the net result is this year, in 2005, there have been no non-tech Chinese companies coming to the United States markets to list, unlike last year where there were several, and if you look at--but in contrast, there have been several very large Chinese IPOs in the last year or so. There was \$1 billion Air China IPO in London and Hong Kong. There was a Shanghai Electric Company IPO of \$700 million in Hong Kong. Shenhua Energy of \$2.95 billion in Hong Kong. China Cosco of 1.2 billion in Hong Kong. Bank of Communications, 1.9 billion.

All these were in Hong Kong. None of these listed in the United States in this last year.

So that's one very important trend. The second trend since the Commission met last April is the fact that there have been a very significant number of venture backed, international venture capital backed companies that have come to the U.S. markets. These are tech companies.

And I have attached to my written submission as Exhibit 1 a listing of the venture backed tech companies that have actually come to the U.S. markets to list in the last few years. What's interesting to note is that the history of these companies coming to U.S. markets was that there were a few of such companies that came during the tech bubble. Similar, in fact, to many of the U.S. tech bubble companies.

That died off in the year 2001-'02. 2003, there was one. 2004, there were actually a significant number, I believe 11 such companies, venture backed companies, tech companies that came to the United States, and this year there have been

already five if you count the one that listed yesterday that priced yesterday. So that is a very significant trend.

All of these are tech companies that get very good valuations in the United States. They would much prefer to be listed in the U.S. than in Hong Kong or some other international market. They're very different in quality and nature and management than ones that you see coming in the SOE, the state-owned sector.

Their management tends to be international. Their boards of directors tend to be peopled by international managers, by venture funds and by people that you might see on the boards of directors of Silicon Valley companies. And increasingly, many, many of these companies are being funded by venture capitalists from the United States or other international venture capital funds.

There is a very large pipeline of these kind of companies being funded in China, and the net result is, of course, that there will be many more IPOs of these companies, most likely in the United

States because they are tech companies, and the United States has the best reputation for being a marketplace for tech companies. We understand tech companies better. The multiples--price multiples for these companies are better.

And the analyst community understand them better, et cetera, et cetera. So I think these are the two trends that I would point out to the Commission. Obviously a lot can happen in one year. A lot is still happening in China. I'm not at all advocating that the loss of these large state-owned enterprise listings in the United States means that we should change or diminish our corporate governance standards or Sarbanes-Oxley or any of that.

I think that the corporate governance, what we have in the United States is the state of the art globally for corporate governance. It is certainly worth noting, though, that we are losing these deals. Maybe over time we will get more of these as Chinese governance, corporate governance improves, and as they're able to raise their level of

corporate governance in China for these state-owned enterprises.

But in the mean time, the good news is that we are getting these tech venture-backed companies coming to the United States, and these I think are probably some of the best governed, managed Chinese companies and probably it's very possible in my mind that they may be the companies of the future for China. They may be the Microsofts, the Googles of the future for China.

So I think these are all worth I think the Commission's consideration.

HEARING CO-CHAIR WESSEL: Thank you. I have a couple of questions I'll start with if that's okay. Let me ask a couple of questions about the business, if you will, of taking these companies to market because you talked about losing out on many of them.

Are our investment firms or our law firms globalizing in the sense that you talked about? I guess the three offices your firm has in China, Goldman I believe is over there. Morgan Stanley,

the others are over there. Are the fees being earned for taking these companies to market in other markets, meaning does your firm take a Chinese company to the Hong Kong Exchange, meaning that you're getting the fee there? Or Morgan if it were to take one of these firms to the London Exchange, that that they're staying away from the U.S. market, while your comment saying that we're not getting the money, we're just getting the money in different places, our firms are?

MR. CHAO: I think that's a perceptive question, yes. I believe that the statistics that I quoted refer to the fees generated by IPOs of Chinese companies regardless of where they were listing outside of China.

HEARING CO-CHAIR WESSEL: Okay.

MR. CHAO: That was international Chinese IPOs.

HEARING CO-CHAIR WESSEL: Does your firm or other U.S.-based firms help take Chinese firms public on other markets?

MR. CHAO: In our case, yes. We help Chinese firms on the Hong Kong Exchange as well.

HEARING CO-CHAIR WESSEL: What are the different independent standards? We heard testimony--I don't know if you were in the room at the time--that Hong Kong has a standard that you have to be a profitable company to go to market there, to be an IPO; is that correct?

MR. CHAO: Yes, on the main board, that's correct.

HEARING CO-CHAIR WESSEL: So that's one of the reasons why they may come here? A tech company which, you know--

MR. CHAO: That's correct.

HEARING CO-CHAIR WESSEL: Not vaporware but ether profits if you will or far out in the future whatever. Vaporware is a different question. As it relates to the independence of directors, the New York Stock Exchange after Sarbanes-Oxley and other reasons, internal reforms as well, has a fairly stringent standard. Does Hong Kong have a similar standard?

MR. CHAO: Hong Kong has very good standards for corporate governance. They have followed many of the leads of the U.S. markets and regulators. They have imposed not as quite a rigorous standard of independent directors, but they have a requirement of a certain number of independent directors, audit committees, and other rules that help transparency and corporate governance.

So I think in general people believe that the Hong Kong rules are good, not as rigorous as the U.S., but good.

HEARING CO-CHAIR WESSEL: Okay. As we look at a company that is moving into, wants to move to a U.S. exchange potentially, how much of an impediment is Sarbanes-Oxley to their activities? I mean is it the cost? Is it the internal structure? Is it the overall reporting and continuity of that reporting? What are the principal impediments?

MR. CHAO: You know I suspect that most Chinese state-owned enterprises when they analyze this issue, they may not analyze it at that level of

detail. I think what they're most concerned about is probably the level of potential liability that they may be incurring, and frankly that kind of liability existed even before Sarbanes-Oxley potentially.

HEARING CO-CHAIR WESSEL: Liability in terms of shareholder?

MR. CHAO: Shareholder suits, class actions.

HEARING CO-CHAIR WESSEL: Securities litigation reform.

MR. CHAO: Yes, exactly. Yes.

HEARING CO-CHAIR WESSEL: Okay.

MR. CHAO: But I think Sarbanes-Oxley has made that even more acute in their eyes because they've heard about the additional burdens and certification requirements, internal controls and cost burdens of Sarbanes-Oxley. But frankly, my sense is that they're most concerned about the liability risk.

HEARING CO-CHAIR WESSEL: Which is independent of S-Ox, of Sarbanes-Oxley?

MR. CHAO: Ironically it goes to a certain extent to the point that was discussed in the earlier panel of do our markets work? Because if they're not coming to our markets because they're concerned about liability and there are the kind of companies that aren't able to comply with our transparency and disclosure requirements, then in a sense maybe we are doing, our rules are doing what they're designed to do.

HEARING CO-CHAIR WESSEL: Correct. Understand. Let me ask you a final question relating to the recent Executive Order on the weapons of mass destruction proliferators. Are you aware of this, that was recently promulgated?

MR. CHAO: I'm sorry?

HEARING CO-CHAIR WESSEL: There was an Executive Order released on June 29 of this year by the president relating to financing essentially of WMD proliferators. Are you aware of this?

MR. CHAO: No, I'm not aware.

HEARING CO-CHAIR WESSEL: Well, let me back up then, a question. Is the question of whether an

entity that's controlled by a Chinese company, since we've seen a number of sales of high tech missile equipment to Iran, et cetera, as a practicing attorney in this area who I assume puts together the blue sky proposals for the IPOs, et cetera, is that a material fact?

To the extent that they are engaged in transactions that potentially could open them up to sanctions under U.S. law, is that something that should be listed in the blue sky as a material fact?

MR. CHAO: Certainly. Anything that impacts the ability of the company to remain within the law, to stay within the bounds of law is material. Anything that might imply the company might be in breach of law, it would be potentially of interest.

HEARING CO-CHAIR WESSEL: Whether it's the entity itself or one of its controlled subsidiaries, I assume that answer would be the same; correct?

MR. CHAO: I think so, yes.

HEARING CO-CHAIR WESSEL: Okay. Thank you.  
Chairman D'Amato.

CHAIRMAN D'AMATO: Thank you, Commissioner Wessel, and thank you very much for your patience and for coming and for your testimony, Mr. Chao. I think you have a great of expertise that is of interest to this Commission in this area.

I'm interested in the differences between the Hong Kong Exchange and the New York Stock Exchange in terms of the standards of performance and so on, including Sarbanes-Oxley. Do you have or do you know of a detailed comparison of the requirements for entry into the two markets and a comparison of the two? We'd be interested in that.

MR. CHAO: I can give you a listing, a comparison of the differences between the two listing requirements, yes. I can provide that. I can give you a list. In fact, I can do better and give you a listing of the requirements for both the New York Stock Exchange, the Nasdaq and Hong Kong Exchange.

CHAIRMAN D'AMATO: We would like to have that. I think that's very important because there is a lot of discussion here about the question of

standards. I'm glad to hear that you don't feel that we should reduce our corporate governance standards, that basically they're state-of-the-art here. Hopefully the rest of the world will come up to that state. We would like that.

MR. CHAO: Right.

CHAIRMAN D'AMATO: My question on Hong Kong is now if the IPO is going to Hong Kong and listing on Hong Kong, then the investors that are investing in that stock, of course, many of those are coming from the United States, and they would be the investors that would have invested in it if it went to the New York Stock Exchange and goes to Hong Kong. I guess my question is when those investors go to Hong Kong--

MR. CHAO: Right.

MR. CHAO: --to invest, what is the difference in the standard of information and disclosure for them at that point in that way as opposed to investing in the New York Stock Exchange, I guess?

MR. CHAO: I understand your point and I think it's a valid point. Very often the very same investors that would otherwise be investing in New York would be investing in Hong Kong.

CHAIRMAN D'AMATO: Yeah.

MR. CHAO: But on the other hand, there are groups of investors that would not. You know, for example, the retail sector. Retail investors have great difficulty getting to the Hong Kong state market and investing in Hong Kong if you're a U.S. retail investor because you would have to find a way to open a retail account in Hong Kong which most people don't have great ease in doing.

CHAIRMAN D'AMATO: Yeah.

MR. CHAO: It tends to be the institutional investors that would invest internationally in that type of situation, a mutual fund.

CHAIRMAN D'AMATO: Yeah.

MR. CHAO: Or a larger institutional investor that has the facilities, the people--

CHAIRMAN D'AMATO: Yeah.

MR. CHAO: --to analyze that market. The disclosure they're getting from Hong Kong is good, but not as detailed--

CHAIRMAN D'AMATO: Yeah.

MR. CHAO: --and not as thorough as you would from the United States.

CHAIRMAN D'AMATO: Yeah. That would be the question in my mind for the--we're concerned about the mutual fund, pension fund participations, the teachers, the firefighters, the police and so on in this country that are relying on their mutual fund managers and their pension fund managers to make good investments.

So that's what we're worried about, that we may be getting, what I call the China bubble, a large number of IPOs coming at once where the standards of disclosure may not be as good for those particular investors in Hong Kong versus the New York Stock Exchange. I guess that's the concern I have.

Because you're saying that the incidents and the pace is picking up.

MR. CHAO: Yes.

CHAIRMAN D'AMATO: And it will be picking up in Hong Kong.

MR. CHAO: Yes. I think Hong Kong and the United States are the two, have historically been the two most important markets by far for Chinese IPOs.

CHAIRMAN D'AMATO: Yeah. Yeah.

MR. CHAO: And I think the trend is now that instead of the large ones coming to the United States, which they historically have done. Every large one historically came to the New York Stock Exchange practically.

CHAIRMAN D'AMATO: Right.

MR. CHAO: Now, the large ones are not coming.

CHAIRMAN D'AMATO: And you're talking SOEs as well.

MR. CHAO: Exactly.

CHAIRMAN D'AMATO: Yes. So the SOE comes to Hong Kong, it's a very big one, and then the question we have is about disclosure. So that

comparison would be very interesting to us to take a look at.

Thank you very much.

MR. CHAO: Sure.

HEARING CO-CHAIR WESSEL: Commissioner Wortzel.

COMMISSIONER WORTZEL: Thank you very much for being here and the long trip, although I question your judgment on leaving the beaches of Greece.

[Laughter.]

COMMISSIONER WORTZEL: I'd like to draw you out on whether or not you can explain how the Chinese government has made or makes its decisions on what companies are allowed to list? And I've got a couple of other questions, but that's a big one for me. What drives the Chinese government to say you can list, you can't? What kind of strategic decisions and what sectors are those decisions--of the economy or of technology are those decisions designed to influence?

Second, what is it that's driving non-technology IPOs away from the U.S.? And technology IPOs here, I guess? And again, does the Chinese government have anything to do with that? Do these corporations have the--or enterprises have the independence to make those decisions?

And then the third thing that struck me is while it might hurt offerors if a Chinese company doesn't list in the U.S., why does it hurt the U.S. economy? And why does that hurt the American investor? Why should we care if they list elsewhere if we're, unless we're interested in the transparency that we might get from the listing?

MR. CHAO: I made a mistake in not writing down all the questions. Please, what was the first one?

COMMISSIONER WORTZEL: The first one, how does the Chinese government make its decisions--

MR. CHAO: Right. I'm sorry. I got it.

COMMISSIONER WORTZEL: --on what companies are allowed to list?

MR. CHAO: On the first question, before I answer that fully, I would like to make one point, and that is the Chinese economy and Chinese companies actually are not lacking in capital. The Chinese economy is flush with capital. So I don't think that the main driving force behind Chinese companies coming to the United State or indeed in international capital markets is to raise money.

They don't really need to come here to get the money. They could raise it domestically. We all know that China has huge amounts of domestic capital. The capital is washing back and forth within the Chinese financial system.

And so you know I think that's one thing we should get off the table, which is that they're coming here primarily to get money, which is--I mean it's clearly a goal, but I'm not sure that that is necessarily the primary, primary goal.

I think one of the reasons the Chinese companies and the Chinese governments chooses the Chinese company to come is because China is not a monolith, there are many different people, there are

many different interest groups, there are many different leaders that have different agendas and different policies just like in the United States, we do.

But one of the things that was clear at a certain level of leadership, at a very high level of leadership, is a belief that if you made a state-owned enterprise go public internationally, you would cause it to shape up. You would make them shape up, you know. If you didn't make them do it, they would never shape up. And so I think one of the things that they were trying to do is because they say a lot of their companies bleeding to death. I mean they had to keep feeding them money; they had to keep making them loans, as you said, you know, and how do they stop that bleeding?

Well, one way to stop that bleeding is to say, look, we're cutting you loose. You're going to be a public company on the New York Stock Exchange or the Hong Kong Stock Exchange, we're not going to give you any subsidies anymore. We're going to give you that one last boost before you go, we're going

to put in some more capital, you know, it's like before you graduate from college, you know, you're going to get that last loan from me, and then after that, you're on your own. And you know you're going to have your own balance sheet, you're going to have your own shareholders. Now we're going to be a shareholder, yeah, but, you know, we're not going to subsidize you anymore in theory--okay--in theory.

And so that's what happens to a lot of these state-owned enterprises. Now, were they successful and are they really companies yet? Are they really independent yet? That's still a question to be debated.

COMMISSIONER WORTZEL: But you're suggesting that the American investor becomes the risk taker as a management and reform tool for the Chinese government and its enterprises?

MR. CHAO: That's what has happened in some cases, yes. Absolutely.

COMMISSIONER WORTZEL: Dick, could I?

CHAIRMAN D'AMATO: Yeah, go ahead.

COMMISSIONER WORTZEL: Then what is driving the technology IPOs away from the U.S. or non-technology IPOs away and technology IPOs here? And does the government have--Chinese government have any influence in those sorts of decisions?

MR. CHAO: I think it certainly has an influence on the move away from the U.S. You know the experience that China Life had and other SOEs have had, the fact that there have been a series of other class action lawsuits against Chinese listings in the U.S., all have created this impression that it's a risky thing to go to the United States to get listed.

And so, you know, why do we need to do that if we can just the money in Hong Kong? And so--

COMMISSIONER WORTZEL: But it's not about money?

MR. CHAO: Well, that's right, but they can still get, they can still achieve those goals that we just talked about--independence, auditing. You know all these audits are by big four accounting firms. You know in corporate governance, you know,

not as rigorously imposed as in the U.S., but still from a reputable well-regarded international exchange, the Hong Kong Exchange.

And we can get that without the risk of liability. You know there are very, very few shareholder lawsuits in Hong Kong. And part of that is because the plaintiff's bar doesn't have the ability to--its legal fees are paid by the loser in Hong Kong so you take a lot of risk. All right. So it's not like if you lose you just take your marbles home and that's it. You have to pay the other side.

COMMISSIONER WORTZEL: Then the third one is why should we care? It might hurt your firm or another law firm if a company doesn't list on the New York Stock Exchange, but why should the American investor care if some Chinese company goes somewhere else?

MR. CHAO: Well, it's a complicated question. You know, in my view, the U.S. capital markets have always been, you know, in the last 100, 150 years the leader. The leader of global capital markets has been the United States. We have the

deepest, most sophisticated, highest volume capital markets in the world. We take public the biggest companies in the world. We trade in the biggest companies. We catch the biggest trends.

What is the biggest trend that's happening economically in the world today? It's the growth of China. Where are the biggest companies in the world going to be coming from in the next ten to 20 to 50 years? Many of them will be Chinese. Where will they raise their capital? Will they raise it in Hong Kong, London, Shanghai or New York?

You know to the extent the New York Stock Exchange, the Nasdaq, do not get their fair share of that business, that will diminish, I think, the competitiveness of our capital markets. So I think there is something to be said about being concerned about that as one of our most important industries in the United States, the financial industry.

COMMISSIONER WORTZEL: Thank you very much. I appreciate your time on that.

HEARING CO-CHAIR WESSEL: Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Commissioner Wessel. Mr. Chao, I really appreciate your being here and really talking so clearly about what is going on. In fact, I even quoted you to the first panel because I read their testimony and I quite--then I read yours to them and then asked them if that was right because I could understand what you were saying. I wasn't quite sure what they were saying. So thank you.

Here we did a hearing out in Palo Alto in April looking at the growth of China's high technology industries and how quickly that is happening. And we looked at the role of apparently American venture capitalists are playing a role in this. So we're playing a role from two ways.

One, our guys are helping identify these companies and then putting some venture capital into them, and then another group like you are bringing them into the market to raise additional money.

If you were just Americans saying, well, I'm worried about our high technology industry versus China's because they seem to be doing awfully

well now, we're running a big trade deficit with them in advanced technology products, about 40 billion a year and growing fast, do you ever think about, and I know that you went to--you're a "Boilermaker," you're a Purdue guy and graduated in engineering, I think.

MR. CHAO: Yeah.

COMMISSIONER MULLOY: Do you ever think about what we should be doing here to better compete in this high tech area?

MR. CHAO: Absolutely. This is one of the hot button subjects of the Silicon Valley. You know I live in the Silicon Valley and have been for the last four years. And I've actually been quite active in the other flow of business you just referred to which is the venture capital investment in the Chinese tech sector. So I see both it coming and going because those are actually two related cycles, as you can imagine, both the investment end and the IPOs out. That's the cycle.

And there are many, many people in the Silicon Valley that are quite concerned about this

because they feel that really what we need to do in this country, in order to keep our competitive edge in the U.S. and in particular in the Silicon Valley in the tech sector is we need to continue to create a number of technical and engineering students that we have historically, and we are not.

We are not keeping pace. And that's one of the number one concerns that many of my clients, colleagues in the Silicon Valley have, is that if you look at the total number of Ph.D.s coming out of China and India, and you compare them with how many we're producing in this country, we're losing the battle of engineers, and engineers are the fodder for technology creation as we all know.

So, the Silicon Valley to my mind is still, you know, the center of the universe when it comes to technology creation. You know we have fantastic companies in the Silicon Valley. We have tremendous technology. We have great innovation in the Silicon Valley, and the Chinese tech sector can't hold a candle to that right now, and I think everybody

knows that. I mean that's acknowledged in China; it's acknowledged in the Silicon Valley.

What we're looking for is projecting down 20 years from now. We're saying we got to get our house in order here--

[Laughter.]

MR. CHAO: I'm sorry. I'm trying to stay proper here. We ought to get our house in order here in order to prepare for the future because we're talking about the long haul of competition. This can be a completely friendly but still competitive relationship we're going to have here, and so if we don't take the right steps in the area of education, then we're going to fall behind.

COMMISSIONER MULLOY: Let me ask you this now. Because that was our impression. There are two things we saw going on. One, we got some things we got to address with China and then there were some things we got to address here at home in order to be competitive with this entity that's really coming on so fast.

Do you have, do you and your group who talk about these things, do you kind of have a list of ten things what you ought to do to get your house in order?

MR. CHAO: You mean on this particular subject?

COMMISSIONER MULLOY: Yeah, yeah.

MR. CHAO: You know I think that education is really the number one issue. It really is the number one issue. If you, there are few other things that people gripe about these days, you know, they'll talk about stock options and the concern that they've had about that, but ultimately that's sort of gone away. I think education is still the number one hot button issue.

COMMISSIONER MULLOY: Thank you, Mr. Chao.

HEARING CO-CHAIR WESSEL: Commissioner Vice Chair, Co-Chair Robinson.

VICE CHAIRMAN ROBINSON: Thank you, Mr. Co-Chairman. Thank you again, Mr. Chao, for joining us. I know it was a long haul and we're very grateful. I'd like to follow up a little bit on

Commissioner Wortzel's points with respect to Hong Kong and the fact that it appears to us that it's almost like a warehousing of deals are coming to Hong Kong.

In other words, this is quite a market movement over the past 12 months in favor of Hong Kong listings versus New York Stock Exchange, for example. And I think that this Commission basically is comfortable, if not favorably inclined, toward the developments on the Nasdaq because the character of those Chinese high tech enterprises is particularly entrepreneurial, particularly commercial in nature, and we, I think--I don't want to speak for all my fellow commissioners, but I think as a whole, we're more comfortable with American investors being involved with genuinely commercial enterprises that are in sort of a bottom line profitability innovation mode.

Where we get concerned, as the chairman has stated and others, is some of the, shall we say, more traditional state-owned SOEs that are involved in everything from the manufacture of refrigerators

to the skins for ICBMs, and who have, you know, Iranian, Sudanese and other operations and a host of other concerns that include, you know, proliferation of weapons of mass destruction and so forth.

I mean that's when it gets complicated from our point of view concerning Chinese state-owned enterprise access to the U.S. capital markets and how that best be managed. No one is suggesting capital controls or restrictions, but we are concerned about the disclosure elements, the governance elements and the impact on our security interests.

So you know I think--you can probably ascertain what we view the challenges to be here. So when you see a plethora of deals coming to Hong Kong, one question I would have would be if so many Chinese state-owned enterprises are coming to the Hong Kong market, is there a risk that the Hong Kong regulatory regime and fairly rigorous disclosure regime, not quite up to our standards, as you've stated--I don't know what that shortfall is, but you're going to help illuminate that matter--could

be further diluted as China, you know, utterly dominates the Hong Kong listing market.

So your view? That's my first question. I mean are we looking at the, again, a chance that Hong Kong as a Hong Kong standards are going to start to or could begin to erode under these pressures, if you will?

Second, can these listed Hong Kong entities more easily come into the U.S. market at a later date because they've already been seasoned? You know they've already been listed for a couple of years in Hong Kong? They're seen as ready for prime time. They've already had their sort of debutante moment, and they're ready for the big time, what was called by another witness the big leagues, namely our deep and sophisticated capital markets? So that's a second question.

The third is--sorry for another list--but the third is Bank of China. Whether you buy the notion that's been put forward today, the Bank of China seems to be intent on the New York Stock Exchange, that they don't want to go the way-station

route or the second tier route of Hong Kong, whereas the China Construction Bank more likely would choose some combination of Hong Kong, Shanghai--I mean, sorry--not--Hong Kong, Singapore, maybe one of the European exchanges or something of that kind.

So I'm just trying to get your sense of whether you think that the Bank of China is the one that's most likely to come to the New York Stock Exchange and what their thinking might be?

Thank you.

MR. CHAO: On the question of the Hong Kong Stock Exchange and whether their standards might be diluted because of the flood of new listings there, you know, one thing I'm told is that the Hong Kong Stock Exchange has a pipeline, a queue of deals, and that basically they will take on more deals as they are able to do.

They have a certain number of people, a certain number of staff, and if they are not able to handle the deals, the queue will just get longer. So that's not a full answer to your question, but

I'm not sure that they just allow themselves to be totally inundated with deals.

Second of all, my sense is that in the long run, the number of SOE listings, whether it's in Hong Kong or the United States, is going to take off. You know China does not have an unlimited number of SOEs. In fact, if you look at what's happened to the Chinese economy, they have basically gotten rid of state-owned enterprises at the small and medium-sized levels now.

You know they've gone through a privatization process where they basically auctioned off, sold off, leased off or otherwise disposed of state-owned enterprises at the small level. It used to be you walked down the street and every, you know, "mom and pop" shop, the grocery store, restaurant was state owned. That's not true anymore. It's all private.

If you look at medium-sized enterprises, many, many, many of those have been auctioned off. Okay. So now you're left with pillar industry and larger companies. Many of those have been IPOed,

some of those have been sold off, some of those are being privatized. There are going to be some that will not ever be IPOed because they're too strategic or too important for the government.

But, you know, over time my personal belief is that you're going to see, as you already have seen in the last ten years, the private sector and the foreign-owned sector get bigger and bigger and bigger over time, the mixed sector if you will, because it's not clear where the lines come anymore.

But it's going to get bigger and bigger and bigger. I mean we know that private enterprise is a powerful force based upon our own economic history, and China is no exception to the natural rules of economics. Private enterprise in China is becoming bigger all the time. So that's--and then also foreign investment which is just another form of private enterprise, of course. That's getting bigger.

The number of IPOs coming out of China eventually I think will be more and more the mid-sized either privately funded, mixed funded or

venture funded companies coming out of China. There will continue to be big IPOs of state-owned enterprises, but I don't think that's an unlimited supply.

As to the standards of the Hong Kong Stock Exchange, in general, I mean my perception is that their reputation continues to be very good.

VICE CHAIRMAN ROBINSON: And the Bank of China question?

MR. CHAO: Just to answer your second question.

VICE CHAIRMAN ROBINSON: Oh, please, yeah.

MR. CHAO: Coming to the U.S., you know, the--

VICE CHAIRMAN ROBINSON: Oh, yeah; right.

MR. CHAO: The fact that companies are listed in Hong Kong I think does prepare them to better list in the United States because it could be viewed as a stepping stone, as a pressure chamber to get, you know, get to the next level.

I don't see that necessarily as a bad thing, that companies' management are better

acclimated to the rigors of corporate governance standards internationally, reporting, disclosure, transparency, auditing. All those things are potentially new to a lot of state-owned enterprises in China.

And then for them to eventually become listed in the United States, if they can make the grade, why not?

As far as Bank of China, I frankly don't have a good window on that. I don't want to speculate on whether they will or will not come to the United States. I really don't know. Sorry.

VICE CHAIRMAN ROBINSON: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner D'Amato.

CHAIRMAN D'AMATO: Thank you, Commissioner Wessel. I think it was mentioned that we had a hearing in April in Palo Alto. We want to get you a copy of that record. We produced a report to the Congress on that. We had a number of high tech companies, venture capitalists. William Perry testified, very interesting testimony. There was

the comment made and Perry ratified it that there was they thought a need for a more structured dialogue between Silicon Valley and Washington, and so we're recommending that, and we'd like to talk to you a little bit more about how is the best way to structure such a dialogue.

In terms of the IPOs coming into the United States in the high tech area, I'm assuming almost all of those go to Nasdaq?

MR. CHAO: All in my list in Exhibit 1 with the exception of SMIC were Nasdaq.

CHAIRMAN D'AMATO: Yeah. So in talking about, we mentioned, one of the messages from that hearing was the question of competitiveness on the part of the United States here, and our education system, and the need for, I think we called for a post-Sputnik type of American educational, federally funded education program in the sciences, engineering and so on to get--in the past, the federal government has been the stimulus for such major programs that have gone on for decades, and we think this is the time again to do such a major

federally funded education program in the United States.

My question to you on the high tech Nasdaq oriented firms, you talked about the question of competition. Can you identify what particular sector or sectors the United States apparently is falling behind in in high tech in terms of the companies that are coming in here in terms of our competitiveness? Is there one or more sectors that you think are particularly of concern that we need to pay attention to?

MR. CHAO: Well, one of the areas where I've heard the concern expressed in particular is the semiconductor industry.

CHAIRMAN D'AMATO: Yes.

MR. CHAO: It is, as you well know, I'm sure, already, true that there are a large number of Chinese foundries and fabs that have been established. Many of the venture companies that we see funded that we either represent or that we represent venture capitalists investing into are semiconductor start-ups. And these are start-ups

that don't have their own fab, they're so-called "fab-less" semiconductor companies which are basically design houses. They design chips.

But it's pretty easy nowadays to go to China and hire engineers that can help you design chips in China for a lot cheaper than in the United States. And so a lot of these start-ups are happening in China through venture money, and you know ultimately this is going to happen one way or the other. I guess the question is are we going to be able to keep a significant portion of the high level, high margin, high value added piece of this industry in the United States?

I mean parts of this are going to go offshore regardless of what we do whether it's going to go to China, it's going to go to Taiwan, it's going to go to India. But we as a country, I think, have an interest in retaining as much of the high value part of this business as possible in the United States, and I'm being told by clients that in order to do this, we need to have more engineers in this country.

CHAIRMAN D'AMATO: Yeah. That's interesting. How would you rate our competitiveness in the biotech area?

MR. CHAO: Biotech, we're way ahead.

CHAIRMAN D'AMATO: Way ahead.

MR. CHAO: Way ahead. You know Asia still is in its infancy when it comes to biotech, whether you're talking about China or other places. But, you know, there's a lot of money being thrown at biotech as well in Asia.

CHAIRMAN D'AMATO: Yeah.

MR. CHAO: Not just China but other places.

CHAIRMAN D'AMATO: Yes, thank you. I'll yield the last few minutes of time to Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you. Thank you, Chairman D'Amato. Yeah, exactly. See biotech, because of our medical system in this country, we pour a lot of money into that and it shows because we're the leaders in it.

But on engineering and semiconductors, for example, we had testimony that the Department of

Defense Defense Science Board was very worried about that industry moving out of this country, semiconductor manufacturing and design, because it's so important to our military capabilities.

And they were making some recommendations. I think it would be useful maybe if we would send that recommendation to your group, the people are thinking about these issues and are in the forefront right now of what is going on in both countries, to help us think through. We want to make some recommendations in that area in our coming report, and if we could ask you to comment, that would be very helpful to us.

MR. CHAO: Be delighted to.

COMMISSIONER MULLOY: Thank you.

CHAIRMAN D'AMATO: Thank you very much.

HEARING CO-CHAIR WESSEL: Great. Thank you. Thank you for your long travels and thank you to the staff for their hard work in preparing us for today, and with that, we will adjourn.

[Whereupon, at 4:50 p.m., the hearing was adjourned.]

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